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No. _____

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.; KNIGHT CAPITAL AMERICAS L.P., FORMERLY KNOWN AS KNIGHT EQUITY MARKETS L.P.; UBS SECURITIES LLC; E*TRADE CAPITAL MARKETS LLC; NATIONAL FINANCIAL SERVICES LLC; AND CITADEL DERIVATIVES GROUP LLC,
Petitioners,

v.

GREG MANNING; CLAES ARNRUP; POSILJONEN AB; POSILJONEN AS; SVEABORG HANDEL AS; FLYGEXPO AB; AND LONDRINA HOLDING LTD.,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Section 27 of the Securities Exchange Act of 1934 provides that federal courts "shall have exclusive jurisdiction" over "violations of [the Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Act] or the rules and regulations thereunder." 15 U.S.C. § 78aa(a).

The Fifth and Ninth Circuits have held that § 27 provides federal jurisdiction over state-law claims seeking to establish liability based on violations of the Act or its regulations or seeking to enforce duties created by the Act or its regulations. In acknowledged conflict with those decisions, the Third Circuit in this case joined the Second Circuit in holding that § 27 does not itself create federal jurisdiction over state-law claims that otherwise fall within its terms.

The question presented is:

Whether § 27 of the Securities Exchange Act of 1934 provides federal jurisdiction over state-law claims seeking to establish liability based on violations of the Act or its regulations or seeking to enforce duties created by the Act or its regulations.

PARTIES TO THE PROCEEDING

Petitioners are Merrill Lynch, Pierce, Fenner & Smith, Inc.; Knight Capital Americas L.P., formerly known as Knight Equity Markets L.P.; UBS Securities LLC; E*TRADE Capital Markets LLC; National Financial Services LLC; and Citadel Derivatives Group LLC, now known as Citadel Securities LLC, defendants below.

Respondents are Greg Manning; Claes Arnrup; Posiljonen AB; Posiljonen AS; Sveaborg Handel AS; Flygexpo AB; and Londrina Holding Ltd., plaintiffs below.

RULE 29.6 STATEMENT

Petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") is an indirect wholly owned subsidiary of Bank of America Corporation, a publicly held corporation. No publicly held company holds 10% or more of Bank of America Corporation's stock.

Petitioner Knight Capital Americas L.P. merged into an entity which became Knight Capital Americas LLC on July 1, 2012. Knight Capital Americas LLC became KCG Americas LLC ("Knight") after the market close on December 31, 2013. Knight is a subsidiary of Knight Capital Group, Inc., which is wholly owned by KCG Holdings, Inc., a publicly traded company. Jefferies Group LLC is a publicly traded company that holds 10% or more of KCG Holdings, Inc.'s stock.

Petitioner UBS Securities LLC is wholly owned by UBS AG and UBS Americas, Inc. UBS Americas,

Inc. is wholly owned by UBS AG, and UBS AG has no parent corporation. Aside from UBS AG and UBS Americas, Inc., no other publicly held company holds 10% or more of the stock of UBS Securities LLC. No publicly held company holds 10% or more of the stock of UBS AG.

Petitioner ETCM Holdings, Inc. ("ETCM") is the sole member of E*TRADE Capital Markets LLC, now known as G1 Execution Services, LLC ("G1"). ETCM owns 100% of G1. ETCM is a direct subsidiary of E*TRADE Financial Corporation, a publicly held corporation. No publicly held company holds 10% or more of G1's stock.

Petitioner National Financial Services LLC ("NFS") is an indirect, wholly owned subsidiary of FMR LLC ("FMR"), which is a privately held corporation. No publicly held corporation owns 10% or more of NFS's or FMR's stock.

Petitioner Citadel Derivatives Group LLC, n/k/a Citadel Securities LLC ("Citadel Securities") has no parent corporation, and no publicly held corporation owns 10% or more of Citadel Securities' stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully request a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit.

OPINIONS BELOW

The decision of the court of appeals is reported at 772 F.3d 158 and is reprinted in the Appendix to the Petition ("App.") at 1a-23a. The district court's opinion is unpublished but is reported at 2013 WL 1164838 and is reprinted at App. 24a-38a.

JURISDICTION

The court of appeals issued its decision on November 10, 2014. App. 2a. A timely petition for rehearing and rehearing en banc was denied on January 15, 2015. App. 40a. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 27 of the Securities Exchange Act of 1934 provides in relevant part:

> The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

15 U.S.C. § 78aa(a).

INTRODUCTION

The decision below exacerbates an acknowledged circuit conflict on an important and recurring question of federal securities law and federal jurisdiction.

Pursuant to the fundamental objective of the federal securities laws to establish a nationally uniform system for regulating securities transactions, § 27 of the Securities Exchange Act provides that the federal courts "shall have exclusive jurisdiction of violations" of the Act or its regulations, and "of all suits in equity and actions at law brought to enforce any liability or duty created by" the Act or its regulations. 15 U.S.C. § 78aa(a).

Consistent with the plain language and purpose of the Act, the Fifth and Ninth Circuits have held that § 27 does just what it says: it confers jurisdiction on federal courts—and only federal courts—over all actions seeking to establish liability based on violations of the Act or its regulations, or seeking to enforce duties created by the Act or its regulations. Explicitly acknowledging a direct conflict with those decisions, the Third Circuit in this case joined the Second Circuit in holding that § 27 does not create federal jurisdiction over actions within its scope. Under the rule that governs in the Second and now Third Circuits, an action otherwise within § 27's scope cannot proceed in federal court unless there is some *other*, independent basis for federal jurisdiction. On this view, § 27's sole function is to strip state courts of concurrent jurisdiction over that type of action.

That view is quite incorrect, and it is an error of exceeding importance. A central objective of the Exchange Act is to subject securities transactions to a single, nationwide system of uniform regulation. The Second and Third Circuits' interpretation of § 27 contravenes that essential objective, effectively empowering fifty-one different state-court systems to enforce the Act's standards and duties.

This case exemplifies the problem, which makes the case an ideal vehicle for resolving it. Both courts below held that respondents' claims, while framed as state-law causes of action, are based on alleged violations of, and seek to enforce duties created by, the SEC's Regulation SHO, which specifies the circumstances under which securities transactions known as "short sales" and "naked short sales" are permissible, and when they are not. The district court held that because respondents' claims were based on alleged violations of Regulation SHO, § 27 establishes federal jurisdiction and thus the case was properly removed from state court. The Third Circuit agreed with the district court that respondents' claims fall within § 27, but held that § 27 did not provide jurisdiction over them because § 27 itself *never* creates jurisdiction. As a result, the standards and duties prescribed by Regulation SHO will now be subject to interpretation by a state-court judge, enforcement by a state-court jury, and review by a state court of appeals formally bound only by state-court precedents on Regulation SHO (of which there are none, of course). That outcome could not be more at odds with the objective of § 27, and with the purpose of federal securities laws more generally.

As intolerable as that result is, it could stand uncorrected for years unless the Court grants certiorari now. On the one hand, remand orders following the Second and Third Circuits' interpretation of § 27 generally will be unappealable under 28 U.S.C. § 1447(d), while on the other hand, orders denying remand under the Fifth and Ninth Circuits' rule will be interlocutory and unappealable for that reason. This case presents a unique opportunity for review because it avoids both problems: the district court denied remand and then certified its order for interlocutory appeal. The Court will not soon see another case with proper appellate jurisdiction presenting the question of § 27's jurisdictional effect. This is the ideal case for review of that important question.

Certiorari should be granted.

STATEMENT OF THE CASE

A. Statutory And Regulatory Background

1. The Securities Exchange Act of 1934 (the "Exchange Act" or "Act") was enacted "[i]n the wake of the 1929 stock market crash and in response to reports of widespread abuses in the securities industry." *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 170 (1994). The Act "is general in scope but chiefly concerned with the regulation of post-distribution trading on the Nation's stock exchanges and securities trading markets." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975).

Section 27 of the Exchange Act provides that federal district courts "shall have exclusive jurisdiction of violations of [the Act] or the rules and regulations

thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Act] or the rules and regulations thereunder." 15 U.S.C. § 78aa(a). "Congress intended § 27 to serve at least the general purposes underlying most grants of exclusive jurisdiction: to achieve greater uniformity of construction and more effective and expert application of" the Exchange Act and the rules and regulations promulgated thereunder. *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 383 (1996) (internal quotation marks omitted).

2. The Exchange Act established the Securities Exchange Commission (the "SEC"), 15 U.S.C. § 78d(a), which has authority to promulgate rules and regulations under the Act. Under that authority, the SEC adopted Regulation SHO, 17 C.F.R. § 242.200 *et seq.*, which governs short sales of equity securities. *See* Short Sales, SEC Release No. 34-50103, 69 Fed. Reg. 48,008 (July 28, 2004).

"Short selling involves a sale of a security that the seller does not own or a sale which is consummated by the delivery of a security borrowed by or on behalf of the seller." "Naked" Short Selling Antifraud Rule, SEC Release No. 34-58774, 73 Fed. Reg. 61,666, 61,667 (Oct. 17, 2008). A short sale normally proceeds as follows: the short seller (1) "identifies securities she believes will drop in market price," (2) "borrows these securities from a broker," (3) "sells the borrowed securities on the open market," (4) "purchases replacement securities on the open market," and (5) "returns them to the broker—thereby closing the short seller's position." *Elec. Trading Grp., LLC v. Banc of Am. Secs. LLC*, 588

F.3d 128, 132 (2d Cir. 2009). "The short seller's profit (if any) is the difference between the market price at which she sold the borrowed securities and the market price at which she purchased the replacement securities, less [transaction costs]." *Id.* Usually, borrowed securities are delivered within three days when the sale transaction is settled. "Naked" Short Selling Antifraud Rule, 73 Fed. Reg. at 61,667 n.7.

In a "naked" short sale, by contrast, the "seller does not borrow or arrange to borrow securities in time to make delivery to the buyer within the standard three-day settlement period." *Id.* at 61,667. "As a result, the seller fails to deliver securities to the buyer when delivery is due." *Id.* This is known as a "fail" or "fail to deliver." *Id.*

While the SEC prohibits "abusive" naked short selling, neither naked short selling generally nor fails to deliver are illegal. *See* SEC Division of Market Regulation: Key Points About Regulation SHO (Apr. 11, 2005). Instead, the SEC has imposed limits on naked short sales and fails to deliver through Regulation SHO and other rules. *See* "Naked" Short Selling Antifraud Rule, 73 Fed. Reg. at 61,667.

Among other things, Regulation SHO imposes "locate" and "close out" requirements on broker-dealers in an attempt to minimize fails to deliver. *See Elec. Trading Grp.*, 588 F.3d at 135-36. The locate requirement requires a broker-dealer, before executing a short-sale order, to have "reasonable grounds to believe" that the security can be borrowed and delivered within three days. 17 C.F.R. § 242.203(b)(1)(ii). If a fail to deliver nonetheless oc-

curs and persists for thirteen days, the close-out requirement calls for broker-dealers to purchase and deliver "securities of like kind and quantity." 17 C.F.R. § 242.203(b)(3).[1] These general locate and close-out requirements are subject to certain exceptions. 17 C.F.R. § 242.203(b)(2)(i)-(iv); *id.* § 242.203(b)(3)(i)-(vii). Regulation SHO's locate requirement, for example, does not apply to short sales executed by market makers in connection with their bona fide market-making activities. *See id.* § 242.203(b)(2)(iii); SEC Division of Market Regulation: Key Points About Regulation SHO ("in certain circumstances, naked short selling contributes to market liquidity").

3. There is no New Jersey analog to Regulation SHO. *See* App. 5a, 9a. The state has not attempted to regulate short sales of securities on the national markets, and it is unlikely New Jersey could do so given the SEC's extensive regulation in this area. *See Levitin v. PaineWebber, Inc.*, 159 F.3d 698, 705-07 (2d Cir. 1998) (holding that, to the extent state-law provision could be read to regulate short sales on the national markets, it was preempted).

B. State And District Court Proceedings

1. Respondent Greg Manning, the lead plaintiff below, is the founder and former CEO of Escala Group, Inc. ("Escala"), a company traded on the NASDAQ until it was delisted in 2007. The other respondents are former Escala shareholders from

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[1] In 2008, after the alleged conduct at issue here, Regulation SHO was amended to require fails to deliver to be closed out within one day. *See* 17 C.F.R. § 242.204.

various countries around the world. *See* App. 45a-46a.

Respondents filed suit against petitioners in the Superior Court of New Jersey. App. 6a, 41a. In their amended complaint, respondents alleged that petitioners—financial institutions that clear and settle securities transactions at the nation's central clearinghouse—"engaged in the unlawful practice of naked short sales of Escala stock by creating, loaning and selling unauthorized, fictitious and counterfeit shares" and by selling or loaning stock "that they did not own, [and] never intended to borrow or locate for delivery to buyers and close-out by settling their trades." *Id.* at 43a, 51a.

Specifically, respondents alleged that petitioners' short sales were unlawful because petitioners "lack[ed] reasonable grounds to believe that the securities could be borrowed and be available for delivery." App. 44a. That allegation mirrors the language of Regulation SHO. *See* 17 C.F.R. § 242.203(b)(1) (prohibiting proprietary or customer short-sale transactions "unless the broker or dealer has . . . [r]easonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due"). Respondents further alleged that petitioners failed to properly "clear out" fails to deliver securities resulting from the short sales. App. 58a. That conduct, too, is addressed by Regulation SHO. *See* 17 C.F.R. § 242.203(b)(3) (requiring broker-dealers to "close out the fail to deliver position by purchasing securities of like kind and quantity" within set number of days). New Jersey

law, by contrast, does not address "locate" and "close out" requirements for short sales.

According to respondents' theory, petitioners' alleged naked short sales "increased the pool of tradable shares" of Escala stock, which, respondents say, caused their shares to decline in value. App. 44a.

Based on their naked-short-selling and counterfeit-share allegations, respondents asserted various state-law claims against petitioners: statutory claims under the New Jersey RICO Act and common-law claims for unjust enrichment, interference with economic advantage and contractual relations, breach of contract, breach of the covenant of good faith and fair dealing, and negligence. *See* App. 82a-101a.

2. Petitioners removed the suit to the United States District Court for the District of New Jersey, asserting federal jurisdiction under § 27 of the Exchange Act and 28 U.S.C. §§ 1331 and 1337. App. 9a, 26a. Respondents sought remand. *Id.* at 9a, 25a.

3. The district court denied respondents' motion to remand. App. 25a. The court began by analyzing the allegations in respondents' complaint. "Notably," the court observed, respondents "do not dispute that the alleged unlawful conduct is predicated on a violation of Regulation SHO." *Id.* at 29a. The court also noted that respondents' complaint relied on the fact that certain petitioners have been fined by the SEC and the Financial Industry Regulatory Authority ("FINRA") "for their intentional and persistent violation" of the rules and regulations governing their

"unlawful" short selling activities. *Id.* at 29a; *see id.* at 44a.

The district court therefore concluded that "the case at bar is premised upon and its resolution depends on the alleged violation of a regulation promulgated under the Act." App. 32a. And because "'Section 27 of the Exchange Act confers exclusive jurisdiction upon the federal courts for suits brought to enforce the Act or rules and regulations promulgated thereunder,'" the court held that § 27 provided federal jurisdiction. *Id.* (quoting *Matsushita Elec. Indus.*, 516 U.S. at 370).

The district court also held that 28 U.S.C. §§ 1331 and 1337 provided federal jurisdiction, applying the test set forth by this Court in *Grable & Sons Metal Products, Inc. v. Darue Engineering & Manufacturing*, 545 U.S. 308 (2005). App. 33a. In doing so, the court reiterated that respondents' claims "are predicated on [petitioners'] alleged naked short sales of Escala stock in violation of SEC Regulation SHO" and respondents would need to "show that the alleged naked short sales were illegal" to prevail on their claims. *Id.* The court further noted that respondents "d[id] not point to a New Jersey law or regulation which similarly prohibits the type of alleged conduct at issue here." *Id.* at 33a-34a.

Noting "substantial ground for difference [of opinion]" regarding the jurisdictional issues raised in this case, the district court certified an interlocutory appeal to the Third Circuit under 28 U.S.C. § 1292(b) to answer "the question of whether remand is appropriate in this case." *Manning v. Merrill*

Lynch, Pierce, Fenner & Smith, Inc., 2013 WL 2285955, at *2 (D.N.J. May 23, 2013).

C. Proceedings Before The Third Circuit

1. The Third Circuit granted respondents' petition to appeal, App. 5a, 10a, and reversed the district court's decision holding that there was federal jurisdiction over respondents' claims.

As a threshold matter, the Third Circuit agreed with the district court that respondents' claims, while nominally asserted under state law, all sought to establish a violation of or enforce a duty created by Regulation SHO. App. 8a-9a. The court emphasized that the complaint "repeatedly mentions the requirements of Regulation SHO, its background, and enforcement actions taken against some [petitioners] regarding Regulation SHO." *Id.* at 8a. The court further observed that the complaint "cites data maintained to assist broker-dealers in complying with Regulation SHO's close out requirement, and at times couches its allegations in language that appears borrowed from Regulation SHO." *Id.* at 8a-9a. The court concluded that "[t]here is no question that Plaintiffs assert in their Amended Complaint, both expressly and by implication, that Defendants repeatedly violated federal law," i.e., Regulation SHO. *Id.* at 9a.

The Third Circuit nevertheless held that § 27 did not establish jurisdiction over respondents' claims. Expressly "disagree[ing]" with decisions of the Fifth and Ninth Circuits, App. 20a & n.9, the court of appeals held that § 27 does not itself confer federal jurisdiction, but instead operates only to "divest state

courts of jurisdiction" over claims that *otherwise* raise federal questions. *Id.* at 22a.[2]

The Third Circuit's construction of § 27 rested on the court's interpretation of *Pan American Petroleum Corp. v. Superior Court of Delaware for New Castle County*, 366 U.S. 656 (1961), which, in the court's view, "all but answered" the question whether § 27 itself provides federal jurisdiction. App. 19a-20a.

In *Pan American*, this Court considered not § 27 of the Exchange Act, but § 22 of the Natural Gas Act, which contains similar exclusive-jurisdiction language. *See* App. 20a. The Third Circuit recited *Pan American*'s observation that, in § 22, "'[e]xclusive jurisdiction' is given the federal courts but it is 'exclusive' only for suits that may be brought in the federal courts. Exclusiveness is a consequence of having jurisdiction, not the generator of jurisdiction because of which state courts are excluded." *Id.* The court read that statement to mean that § 22 of the Natural Gas Act could never provide federal jurisdiction where it did not otherwise exist under § 1331 and saw "no reason" to distinguish between § 22 of the Natural Gas Act and § 27 of the Exchange Act. *Id.*

Based on that reasoning, the court of appeals "disagree[d]" with the decisions of the Fifth and

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[2] The Third Circuit separately held that respondents' complaint did not on its face "necessarily raise" a federal question under § 1331, applying the four-part test identified in *Grable*, 545 U.S. at 314. App. 12a. That question is distinct from the question whether § 27 itself creates jurisdiction over a state-law claim that asserts a violation of or seeks to enforce a duty created by Regulation SHO.

Ninth Circuits holding that "there can be jurisdiction under § 27 (and other exclusive jurisdiction provisions) even when there is not under § 1331." App. 20a; *see id.* at 20a n.9. The court instead "agree[d]" with the Second Circuit's holding "that § 27 is coextensive with § 1331 for purposes of establishing subject-matter jurisdiction." App. 22a; *see Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 55 (2d Cir. 1996). Section 27, the court concluded, "does not provide an independent basis to exercise jurisdiction" over respondents' claims. App. 22a.

2. Petitioners timely filed a petition for rehearing and rehearing en banc, which was denied. App. 40a.

REASONS FOR GRANTING THE PETITION

Certiorari should be granted to resolve a direct, acknowledged conflict between the Second and Third Circuits, on the one hand, and the Fifth and Ninth Circuits on the other, on a frequently recurring federal securities law question of great importance.

I. THE THIRD CIRCUIT'S HOLDING THAT § 27 DOES NOT PROVIDE FEDERAL JURISDICTION CONFLICTS WITH OTHER CIRCUIT DECISIONS AND IS INCONSISTENT WITH DECISIONS OF THIS COURT

A. A Direct, Acknowledged Conflict Exists Among Circuit Decisions On The Question Presented

Both the Third Circuit below and the Second Circuit have acknowledged the existence of a circuit

conflict regarding whether § 27 can provide federal jurisdiction where § 1331 does not. *See* App. 18a-19a; *NASDAQ OMX Grp., Inc. v. UBS Secs., LLC*, 770 F.3d 1010, 1030 (2d Cir. 2014).

1. The Fifth and Ninth Circuits have held that § 27 itself creates federal jurisdiction, regardless whether § 1331 separately applies.

In *Hawkins v. National Association of Securities Dealers, Inc.*, 149 F.3d 330 (5th Cir. 1998), the Fifth Circuit held that § 27 provided federal jurisdiction without conducting any analysis under § 1331. *Id.* at 331-32. The plaintiff in *Hawkins* brought state-law claims alleging that the National Association of Securities Dealers ("NASD," which is now FINRA) was biased against him, failed to properly administer an arbitration proceeding, and conspired with the defendant to deprive him of a fair arbitration. *See id.* at 330-31.

The Fifth Circuit noted that, to the extent the plaintiff's claims alleged "that the NASD breached duties it owed to [him] in its role as arbitrator, those duties arise from the NASD Code of Arbitration Procedure, which is a body of rules approved by the Securities Exchange Commission and promulgated under 15 U.S.C. § 78s." *Id.* at 331-32. Likewise, the court reasoned, to the extent the plaintiff claimed that "the NASD conspired with" or "failed to adequately supervise" the defendant, the plaintiff had "alleged violations of 15 U.S.C. §78*o*-3, the statute which allows the registration of the NASD as a self-regulating exchange, and 15 U.S.C. § 78s(g), which requires the NASD to enforce compliance with applicable securities statutes, rules, and regulations." *Id.*

at 332. The court therefore concluded that the plaintiff's claims, "though carefully articulated in terms of state law," sought "to enforce liabilities or duties created by federal securities laws which are governed exclusively by federal courts" under § 27. *Id.* As a result, there was federal jurisdiction over those claims. *See id.*

The Ninth Circuit reached the same conclusion on materially identical facts in *Sparta Surgical Corp. v. National Association of Securities Dealers, Inc.*, 159 F.3d 1209 (9th Cir. 1998). In *Sparta*, the plaintiff asserted only state-law claims, but alleged that the defendant's conduct violated NASD rules. *See id.* at 1211. The Ninth Circuit held that, because the plaintiff's complaint "sought relief based upon violation of exchange rules, subject matter jurisdiction was specifically vested in the federal district court under the Exchange Act." *Id.*

Section 27, the court correctly explained, "unequivocally 'confers exclusive jurisdiction upon the federal courts for suits brought to enforce the Act or rules and regulations promulgated thereunder.'" *Id.* at 1211-12 (quoting *Matsushita Elec. Indus.*, 516 U.S. at 370). And the plaintiff's theories, while "posited as state law claims," were "founded on the defendants' conduct in suspending trading and delisting the offering, the propriety of which must be exclusively determined by federal law." *Id.* at 1212. The plaintiff had "specifically alleged violation of exchange rules, a matter committed exclusively to federal jurisdiction," and "[w]hen a plaintiff chooses to plead what 'must be regarded as a federal claim,' then 'removal is at the defendant's option.'" *Id.* at

1213 (quoting *Caterpillar, Inc. v. Williams*, 482 U.S. 386, 399 (1987)).

The Ninth Circuit adhered to that interpretation of § 27 in *Lippitt v. Raymond James Financial Services*, 340 F.3d 1033 (9th Cir. 2003). In *Lippitt*, the court held that a state-law claim that did not seek "enforcement of any [securities] rule or regulation" fell outside the scope of § 27. *Id.* at 1037. But in reaching that conclusion, the court explained that "if [the plaintiff] were asserting a violation of an SRO rule, then . . . this would be a matter of exclusive federal jurisdiction, and therefore removal would be proper." *Id.* at 1042 (citing § 27); *see also Sacks v. Dietrich*, 663 F.3d 1065, 1068-69 (9th Cir. 2011); *Cal. ex rel. Lockyer v. Dynegy, Inc.*, 375 F.3d 831, 839-43 (9th Cir. 2004).

Numerous district court decisions outside the Fifth and Ninth Circuits have adopted the same interpretation of § 27. *See, e.g., Shimoda-Atl., Inc. v. Fin. Indus. Regulatory Auth., Inc.*, 2008 WL 2003160, at *3-4 (W.D. Ark. May 8, 2008); *Whitehall Wellington Invs., Inc. v. Nat'l Ass'n of Secs. Dealers, Inc.*, 2000 WL 1846129, at *4 & nn.4-5 (S.D. Fla. Dec. 7, 2000); *Lowe v. NASD Regulation, Inc.*, 1999 WL 1680653, at *3 (D.D.C. Dec. 14, 1999).

2. In direct, acknowledged conflict with the foregoing precedents, the Third Circuit below held that § 27 does not provide federal jurisdiction where there is not already jurisdiction under § 1331. App. 22a. Section 27, the Third Circuit said, is merely "coextensive with § 1331 for purposes of establishing subject-matter jurisdiction" and serves only to "divest state courts of jurisdiction" over cases within its

scope. *Id.* The court therefore concluded that "§ 27 does not provide an independent basis to exercise jurisdiction" over respondents' claims, *id.*, even though respondents alleged that petitioners "repeatedly violated" a federal securities regulation, *id.* at 9a.

In reaching that conclusion, the Third Circuit "agree[d]" with the Second Circuit's decision in *Barbara v. New York Stock Exchange, Inc.*, 99 F.3d 49 (2d Cir. 1996). App. 22a. In *Barbara*, the Second Circuit limited § 27's scope to claims for which federal jurisdiction would already exist under § 1331—"claims created by the [Exchange] Act or by rules promulgated thereunder." 99 F.3d at 55. The court specifically rejected the notion that § 27 also reaches "claims created by state law." *Id.*; *see also Fairfax Fin. Holdings Ltd. v. S.A.C. Capital Mgmt., LLC*, 2007 WL 1456204, at *5 (D.N.J. May 15, 2007) ("agree[ing]" with *Barbara*); *Raser Techs., Inc. v. Morgan Stanley & Co.*, 2012 U.S. Dist. LEXIS 189029, at *14 (N.D. Ga. Oct. 30, 2012) (limiting § 27's scope to suits expressly brought under the Exchange Act).[3]

3. The circuit conflict expanded by the Third Circuit's decision even goes beyond § 27. Two other statutes—the Natural Gas Act ("NGA") and the Fed-

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[3] It is not clear that the Second Circuit would follow the approach adopted in *Barbara* if it considered the issue anew today. The Second Circuit has limited *Barbara*'s application in more recent cases and has thus far avoided reconsidering the effect of § 27 by finding jurisdiction under § 1331. *See NASDAQ*, 770 F.3d at 1030; *D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 100-04 (2d Cir. 2001). *Barbara* therefore remains controlling in the Second Circuit.

eral Power Act ("FPA")—include "exclusive jurisdiction" provisions nearly identical to § 27, *see* 15 U.S.C. § 717u (NGA § 22); 16 U.S.C. § 825p (FPA § 317), and a nearly identical circuit conflict has arisen over the interpretation of those provisions as well.

In *Lockyer*, the Ninth Circuit applied its decision in *Sparta* construing § 27 to FPA § 317 and held that § 317 likewise confers federal jurisdiction on claims within its terms. *See Lockyer*, 375 F.3d at 839-43. And at least one district court within the Ninth Circuit has applied *Sparta* and *Lockyer* to reach the same conclusion for NGA § 22. *See Pacificorp v. Northwest Pipeline GP*, 2010 WL 3199950, at *5-6 (D. Or. June 23, 2010), *report and recommendation adopted*, 2010 WL 3219533 (D. Or. Aug. 9, 2010).

The Seventh Circuit similarly recognized in *Northeastern Rural Electric Membership Corp. v. Wabash Valley Power Associates, Inc.*, 707 F.3d 883 (7th Cir. 2013), that FPA § 317 provides an independent basis for federal jurisdiction, although the court ultimately concluded that § 317 was not satisfied on the particular facts of that case. *Id.* at 892.

In conflict with those decisions, the Sixth Circuit held in *Columbia Gas Transmission, LLC v. Singh*, 707 F.3d 583 (6th Cir. 2013), that NGA § 22 does not supply federal jurisdiction where there is not otherwise federal jurisdiction under § 1331. *Id.* at 591 (NGA § 22 "does not create the cause of action or substantial federal interest required for federal-

question jurisdiction").[4]

Viewed together with the decisions construing Exchange Act § 27, the decisions addressing FPA § 317 and NGA § 22 expand the circuit conflict from an evenly divided four circuits to an evenly divided six: the Fifth, Seventh, and Ninth Circuits all correctly recognize that the materially identical "exclusive jurisdiction" provisions of these statutes create jurisdiction even when the requirements of § 1331 are not separately satisfied, whereas the Second, Third, and Sixth Circuits all hold that the provisions do not confer jurisdiction independent of § 1331.

This case, in short, presents a broad and direct circuit conflict on the same jurisdictional issue affecting three separate federal regulatory regimes. It is difficult to imagine a more compelling basis for certiorari.

B. The Third Circuit's Holding Is Inconsistent With This Court's Precedents

The conflict over § 27 (and the similar provisions of other statutes) has arisen not *because* of any lack of clarity in this Court's own precedents, but *despite* a perfectly consistent pattern of referring to § 27 as a jurisdiction-creating statute.

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[4] The Third Circuit in this case cited the Sixth Circuit's earlier decision in *Marel v. LKS Acquisitions, Inc.*, 585 F.3d 279 (6th Cir. 2009), as consistent with the Second Circuit's holding in *Barbara*. *See* App. 18a-19a n.6. But in *Marel* the federal issue arose only "as a possible defense to a state law claim." 585 F.3d at 280. *Marel* accordingly did not answer the question of whether § 27 provides federal jurisdiction where, as here, a federal securities-law issue is presented *on the face of the complaint*. *See also infra* at 24-25.

In *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), for example, the Court observed that the district court "had jurisdiction under 15 U.S.C. § 78aa [§ 27] to adjudicate the question whether § 10(b) applies to [the defendant's] conduct." *Id.* at 254.[5] Similarly, in *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979), the Court stated that "Section 27 grants jurisdiction to the federal courts." *Id.* at 577. And in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), the Court observed that § 27 "specifically grants the appropriate District Courts jurisdiction over 'all suits in equity and actions at law brought to enforce any liability or duty created' under the Act." *Id.* at 431.

The Third Circuit's decision in this case cannot be reconciled with any of those decisions. In the Third Circuit's view, § 27 does not "grant" anything to federal courts, but merely takes concurrent jurisdiction from state courts. *See* App. 22a. On that view, a federal court cannot "have jurisdiction" under § 27, but only under § 1331 or some other jurisdiction-conferring statute. The chasm between the Second and Third Circuits' construction of § 27 and this Court's longstanding, contrary understanding of the provision warrants review.

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[5] In *United States v. Yousef*, 750 F.3d 254 (2d Cir. 2014), the Second Circuit recognized that in *Morrison* "subject-matter jurisdiction was established by [§ 27], which grants district courts original jurisdiction over federal securities law claims." *Id.* at 261-62. The court did not acknowledge the tension between that observation and its earlier decision in *Barbara*.

II. THE SECOND AND THIRD CIRCUITS' VIEW THAT § 27 DOES NOT PROVIDE FEDERAL JURISDICTION IS INCORRECT

A. Section 27's Plain Language Creates Federal Jurisdiction

Section 27 states that the federal district courts "shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Act] or the rules and regulations thereunder." 15 U.S.C. § 78aa(a).

That language encompasses the claims asserted in respondents' complaint. As the Third Circuit recognized, respondents' complaint "both expressly and by implication" alleges, as the basis for liability under state law, that petitioners "repeatedly violated federal law"—specifically, Regulation SHO, an SEC regulation promulgated under the Exchange Act. App. 9a. The court of appeals further observed that there is no state-law analog of Regulation SHO on which respondents' state-law claims could rest. *Id.* Respondents' claims thus unambiguously seek to obtain relief for a violation of Regulation SHO and to enforce the duties created by Regulation SHO. Under the plain terms of § 27, the federal courts have "exclusive jurisdiction" over those claims.

Congress frequently uses the phrase "shall have jurisdiction" to create federal jurisdiction—indeed, it is impossible to construe that phrase any other way. *Compare* 28 U.S.C. § 1291 ("The courts of appeals . . . shall have jurisdiction of appeals from all final deci-

sions of the district courts of the United States . . . except where a direct review may be had in the Supreme Court.") *with Gelboim v. Bank of Am. Corp.*, 135 S. Ct. 897, 902 (2015) ("Section 1291 gives the courts of appeals jurisdiction over appeals from 'all final decisions of the district courts of the United States.'").[6] The sole difference in § 27 is the inclusion of the modifier "exclusive" before "jurisdiction." Under the Second and Third Circuits' interpretation, the addition of the word "exclusive" somehow *undoes* the grant of federal jurisdiction achieved by the common phrase "shall have jurisdiction." That construction makes no sense at all. If anything, adding the word "exclusive" only underscores Congress's interest in ensuring federal-court supervision over claims that fall within the provision's scope—such claims not only are subject to federal jurisdiction, but they are subject *only* to federal jurisdiction.

The specific jurisdictional language reflected in § 27 is different from, and broader than, the general "arising under" language of § 1331, confirming that § 27 is *not* "coextensive with § 1331," as the Third

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[6] *See also* 7 U.S.C. § 1642(e) ("The district courts of the United States shall have jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."); 15 U.S.C. § 378(a) ("The United States district courts shall have jurisdiction to prevent and restrain violations of this chapter and to provide other appropriate injunctive or equitable relief, including money damages, for the violations."); 33 U.S.C. § 1232(d) ("The United States district courts shall have jurisdiction to restrain violations of this chapter or of regulations issued hereunder, for cause shown.").

Circuit held. App. 22a. Section 27 broadly encompasses "*all* suits in equity and actions at law brought to enforce *any* liability or duty created by" the Exchange Act or its regulations. The question thus is not whether the claim is sufficiently federal in character to say that it "arises under" federal law, but simply whether the claim seeks to enforce an Exchange Act liability or duty. If so, the federal court "shall have . . . jurisdiction" over it, and "exclusive" jurisdiction to boot. The language of § 27 could not be clearer.

B. Construing § 27 In Accordance With Its Plain Language Also Advances Its Purposes

The Third Circuit's approach is not only irreconcilable with the statutory text, but also undermines § 27's central purpose: "'to achieve greater uniformity of construction and more effective and expert application of that law.'" *Matsushita Elec. Indus.*, 516 U.S. at 383 (quoting *Murphy v. Gallagher*, 761 F.2d 878, 885 (2d Cir. 1985)).

This case concerns short sales of securities on the national market, which are subject to comprehensive regulation under Regulation SHO. Under the guise of state-law claims, respondents accuse petitioners of engaging in naked short sales that violate Regulation SHO. Respondents are thus attempting to use state law to enforce duties imposed by the Exchange Act and regulations promulgated thereunder, and they are seeking to do so in state court, where state-court judges and juries will decide whether petitioners have violated the federal standards on which respondents' claims rely. This is exactly the type of

situation § 27 was intended to prevent. Indeed, the "danger" presented where state-court judges "who are not fully expert in federal securities law" endeavor to interpret and enforce those laws, *Matsushita Elec. Indus.*, 516 U.S. at 383, is particularly acute here, where the federal regulation at issue—Regulation SHO—is highly technical and complex.

C. The Third Circuit Misconstrued This Court's Decision In *Pan American*

The Third Circuit largely ignored § 27's language and purpose, relying instead on this Court's decision in *Pan American*, which the court deemed dispositive. *See* App. 19a-20a. *Pan American*, however, is not on point at all, much less dispositive.

Pan American involved NGA § 22, which—as discussed above, *supra* at 17-19—has the same jurisdictional language as Exchange Act § 27. But unlike here, where respondents asserted state-law claims premised on violations of Regulation SHO, the complaint in *Pan American* alleged a state-law claim for breach of contract that did *not* invoke any violation of federal law as the basis for liability. 366 U.S. at 662-64. Instead, federal issues under the NGA arose only as a *defense* to the alleged state-law breach of contract. *See id.*

The defendant objected to state-court jurisdiction on the basis of NGA § 22's "exclusive jurisdiction" language, but this Court held—applying what later became known as the "well-pleaded complaint" rule—that federal jurisdiction can arise only when the federal issue appears on "the face of the complaint," regardless of whether the "defendant is al-

most certain to raise a federal defense." *Id.* at 663. The "exclusive jurisdiction" language of NGA § 22 did not alter that long-settled rule, the Court explained: "'Exclusive jurisdiction' is given the federal courts but it is 'exclusive' only for suits that may be brought in the federal courts. Exclusiveness is a consequence of having jurisdiction, not the generator of jurisdiction because of which state courts are excluded." *Id.* at 664.

The Third Circuit misread that passage to mean that an "exclusive jurisdiction" provision does not create federal jurisdiction when the face of the complaint raises exactly the federal issue over which federal courts are to have exclusive jurisdiction—here, enforcement of a duty created by an Exchange Act regulation. *See* App. 20a. Read in context, however, the cited passage merely confirms that an "exclusive jurisdiction" provision does not overcome the long-settled well-pleaded complaint rule requiring that jurisdiction be assessed based on the claims asserted by the plaintiff on the face of the complaint. Because respondents' complaint here on its face *does* assert violations of Regulation SHO as the basis for liability, the rule applied in *Pan American* creates no barrier to federal jurisdiction in this case. The Third Circuit's contrary conclusion was incorrect.

III. THE QUESTION PRESENTED IS A RECURRING ISSUE OF NATIONAL IMPORTANCE, AND THIS CASE PRESENTS AN IDEAL VEHICLE FOR RESOLVING IT

The question presented is a recurring issue of national importance. The numerous circuit and district court decisions already cited demonstrate the fre-

quency with which the issue arises. And its significance is commensurate with the importance of the federal securities laws' core objective of subjecting securities transactions to a uniform national regulatory system.

The Third Circuit's decision, if left to stand, will seriously disrupt that system. It will encourage forum shopping by plaintiffs who would dress up alleged violations of federal securities law in state-law garb. The decision below will also permit state courts within the Third Circuit to insert themselves into the regulation of trade settlement and clearing for securities transactions executed on national exchanges. As a result, participants in the national securities markets will be required to look to the varied precedents of the states to determine what rules and standards may apply to their trading activities. The decision below will thus generate substantial uncertainty and confusion for market participants—the opposite of what Congress intended.

Further, as discussed above, the jurisdictional issue here is not limited to § 27, but applies equally to the NGA and the FPA. Like the Exchange Act and securities regulation, those laws reflect a judgment by Congress that the interstate allocation and transportation of energy requires a nationally uniform regulatory system—an objective thwarted when federal regulatory standards and duties become enforceable in state courts through state-law vehicles.

Finally, this case presents an ideal vehicle for resolving the jurisdictional controversy and restoring the uniformity Congress intended in the Exchange Act and other statutes. The Third Circuit below rec-

ognized that there is "no question" that respondents' complaint alleged that petitioners "repeatedly violated" Regulation SHO. App. 9a. The question whether § 27 provides federal jurisdiction is thus clearly and cleanly presented here. If this Court were to disagree with the Third Circuit and hold that § 27 does provide federal jurisdiction, the Third Circuit's recognition that respondents have alleged violations of federal securities regulations would necessarily lead to the conclusion that there is federal jurisdiction over respondents' claims. It was only by holding that § 27 requires a separate, independent basis for federal jurisdiction that the Third Circuit was able to deny federal jurisdiction in this case.

If the Court declines to address the question presented in this case, the circuit conflict is likely to fester for years without presenting another opportunity for this Court to intervene and establish a uniform federal rule. Application of the Third Circuit's reading of § 27 will result in remand of cases raising federal securities-law issues as a predicate for state-law liability, and there is ordinarily no appellate review of a remand order based on a lack of jurisdiction. 28 U.S.C. § 1447(d) ("An order remanding a case to the State court from which it was removed is not reviewable on appeal or otherwise."); *see Kircher v. Putnam Funds Trust*, 547 U.S. 633, 648 (2006) (holding that § 1447(d) bars appellate review of remand orders in cases removed under SLUSA). It will thus be difficult to obtain review of future decisions applying the Third Circuit's holding in this case. Now is the time, and this is the case, to determine conclusively whether § 27 means what it says.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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March 17, 2015

APPENDIX

APPENDIX A

COURT OF APPEALS OPINION

PRECEDENTIAL

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 13-3693

GREG MANNING; CLAES ARNRUP; POSILJONEN AB; POSILJONEN AS; SVEABORG HANDEL AS; FLYGEXPO AB; LONDRINA HOLDING LIMITED,
Appellants

v.

MERRILL LYNCH PIERCE FENNER & SMITH, INC.; KNIGHT CAPITAL AMERICAS, a/k/a Knight Equity Markets L.P.; UBS SECURITIES LLC; E TRADE CAPITAL MARKETS LLC; NATIONAL FINANCIAL SERVICES LLC; CITADEL DERIVATIVES GROUP LLC; JOHN DOES 1-10 (names being fictitious); ABC COMPANIES (names being fictitious), jointly, severally or in the alternative, individually

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On Appeal from the United States District Court
for the District of New Jersey
District Court No. 2-12-cv-04466
District Judge: The Honorable Jose L. Linares

Submitted Pursuant to Third Circuit L.A.R. 34.1(a)
July 10, 2014

Before: SMITH, VANASKIE, and SLOVITER,
Circuit Judges

(Filed: November 10, 2014)

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OPINION

SMITH, *Circuit Judge.*

After the District Court denied Plaintiffs' motion to remand this case to New Jersey state court, we granted their petition for an interlocutory appeal. The issue before us is whether there is federal-question jurisdiction over Plaintiffs' state-law claims, which allege that defendants manipulated the price of a stock via abusive "naked" short sales. Short sales are subject to detailed federal regulation under Regulation SHO. New Jersey does not have an analogous provision. However, the question of whether the naked short selling at issue in this case violates New Jersey law (including the state's general securities fraud provisions) need not be answered by reference to Regulation SHO. Because the success of Plaintiffs' state-law causes of action does not "necessarily" depend upon the contents of federal law, this case does not "arise under" the laws of the United States. The presence of an exclusive jurisdiction provision governing Regulation SHO

does not change the analysis, as such provisions cannot independently generate jurisdiction.

We hold that there is no federal-question jurisdiction over this suit. Accordingly, we will reverse the order denying remand, and direct the District Court to remand this case to the Superior Court of New Jersey.

I.

Plaintiffs are shareholders in Escala Group, Inc. ("Escala"). Named Defendants are financial institutions that engage in equity trading. Plaintiffs filed this lawsuit in the Superior Court of New Jersey alleging that Defendants participated in "naked" short selling of Escala stock, which "increased the pool of tradable shares by electronically manufacturing fictitious and unauthorized phantom shares." (Am. Compl. ¶ 4.) Plaintiffs also refer to these shares as "counterfeit." (Am. Compl. ¶ 37.) Plaintiffs claim that this alleged increase in Escala shares diluted their voting rights and caused their shares to decline in value. The Amended Complaint pleads ten causes of action, with all claims asserted under New Jersey law. These causes of action address: (i) claims under the New Jersey Racketeer Influenced and Corrupt Organizations ("RICO") Act based on predicate acts of New Jersey securities fraud and theft; and (ii) common law claims for unjust enrichment, interference with economic advantage and contractual relations, breach of contract, breach of the covenant of good faith and fair dealing, and negligence.

A normal (i.e., non-naked) short sale is usually accomplished in six steps: (1) "[t]he short seller identifies securities she believes will drop in market price;" (2) arranges to "borrow[] these securities from a broker;" (3) "sells the borrowed securities on the open market;" (4) waits some period of time hoping the securities decline in value; (5) "purchases replacement securities on the open market;" and (6) "returns them to the broker—thereby closing the short seller's position." *Elec. Trading Grp., LLC v. Banc of Am. Sec. LLC*, 588 F.3d 128, 132 (2d Cir. 2009). "The short seller's profit (if any) is the difference between the market price at which she sold the borrowed securities and the market price at which she purchased the replacement securities, less [transaction costs]." *Id.* Usually a buyer takes delivery of the borrowed securities within three days following the purchase. Amendments to Regulation SHO, SEC Release No. 34-58773, 73 Fed Reg. 61706, 61707 n.8 (Oct. 14, 2008).

However, "[i]n a 'naked' short sale . . . the short seller does not borrow securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due (known as a 'fail' or 'fail to deliver'). Sellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security, or possibly to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high." *Id.* at 707-08. Naked short selling is not per se illegal under federal law. However, some naked short selling

schemes may run afoul of federal antifraud laws, as well as Regulation SHO. 'Naked' Short Selling Antifraud Rule, SEC Release No. 34-58774, 73 Fed. Reg. 61666, 61667 (Oct. 14, 2008).

Regulation SHO, 17 C.F.R. § 242.200 *et seq.*, was adopted in 2004 by the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to its authority under the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78a *et seq.* *See* Short Sales, SEC Release No. 34-50103, 69 Fed. Reg. 48008 (July 28, 2004). Among other restrictions, Regulation SHO imposes "locate" and "close out" requirements on broker-dealers in an attempt to minimize fails to deliver. Under the locate requirement, before executing a short sale order, a broker-dealer must have "reasonable grounds" to believe that the security can be borrowed and delivered within three days. 17 C.F.R. § 242.203(b)(1). If a fail to deliver has occurred and persists for thirteen days, under the "close out" requirement broker-dealers may be required to purchase and deliver securities "of like kind and quantity." 17 C.F.R. § 242.203(b)(3); *Elec. Trading Grp.*, 588 F.3d at 135-36.

Although Plaintiffs' causes of action are all brought under state law, the Amended Complaint repeatedly mentions the requirements of Regulation SHO, its background, and enforcement actions taken against some Defendants regarding Regulation SHO. It also cites data maintained to assist broker-dealers in complying with Regulation SHO's close out requirement, and at times couches its allegations in language that appears borrowed

from Regulation SHO. Further, plaintiffs plead that "Defendants violated the trading rules and regulations requiring that they actually deliver shares . . . to settle short sale transactions." (Am. Compl. ¶ 33.) There is no question that Plaintiffs assert in their Amended Complaint, both expressly and by implication, that Defendants repeatedly violated federal law. Moreover, there is no New Jersey analogue to Regulation SHO.

Defendants removed the suit from the Superior Court of New Jersey to the United States District Court for the District of New Jersey, premised on the existence of federal-question jurisdiction. Plaintiffs sought remand. On December 31, 2012, the Magistrate Judge issued a Report and Recommendation suggesting that Plaintiffs' motion to remand be granted: "because [Plaintiffs] may succeed on their New Jersey RICO claims . . . and state common law claims . . . without establishing liability under federal law, the Amended Complaint, on its face, does not raise necessarily a substantial issue of federal law." *Manning v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 12–4466, 2012 WL 7783142, at *4 (D.N.J. Dec. 31, 2012). The District Court disagreed in a March 20, 2013 opinion: "the case at bar is premised upon and its resolution depends on the alleged violation of a regulation promulgated under the [Exchange] Act." *Manning v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 12–4466, 2013 WL 1164838, at *4 (D.N.J. Mar. 20, 2013).

Noting "substantial ground for difference [of opinion] here, as evinced by the different outcome

reached by this Court and [the] Magistrate Judge . . . in this case," on May 23, 2013, the District Court certified an interlocutory appeal to this Court, pursuant to 28 U.S.C. § 1292(b), to answer "the question of whether remand is appropriate in this case." *Manning v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 12–4466, 2013 WL 2285955, at *2 (D.N.J. May 23, 2013). On August 28, 2013, we granted Plaintiffs' petition to appeal.

II.

Defendants removed this suit to federal court pursuant to 28 U.S.C. § 1441, asserting federal jurisdiction under 28 U.S.C. §§ 1331 and 1337 and 15 U.S.C. § 78aa. We have jurisdiction over this interlocutory appeal pursuant to 28 U.S.C. § 1292(b).

"We exercise plenary review over [a] district court's order denying [a] motion for remand." *Werwinski v. Ford Motor Co.*, 286 F.3d 661, 665 (3d Cir. 2002).

III.

The sole issue on appeal is whether there is federal-question jurisdiction over Plaintiffs' claims. "The removing party . . . carries a heavy burden of showing that at all stages of the litigation the case is properly before the federal court. Removal statutes are to be strictly construed, with all doubts to be resolved in favor of remand." *Brown v. Jevic*, 575 F.3d 322, 326 (3d Cir. 2009) (internal citations omitted). Defendants point to two principal statutory provisions they believe confer

jurisdiction here: 28 U.S.C. § 1331 and 15 U.S.C. § 78aa ("§ 27" of the Exchange Act).[1] Section 1331, the "general federal-question statute," *Michigan v. Bay Mills Indian Cmty.*, 134 S. Ct. 2024, 2030 n.2 (2014), gives district courts original jurisdiction over "all civil actions arising under the Constitution, laws, or treaties of the United States." Section 27 gives district courts "exclusive jurisdiction . . . of all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder."

A.

Section 1331 "is invoked by and large by plaintiffs pleading a cause of action created by federal law." *Grable & Sons Metal Prods., Inc. v. Darue Eng'g & Mfg.*, 545 U.S. 308, 312 (2005); *see also Gunn v. Minton*, 133 S. Ct. 1059, 1064 (2013) ("Most directly, a case arises under federal law when federal law creates the cause of action asserted.") (citing *Am. Well Works Co. v. Layne & Bowler Co.*, 241 U.S. 257, 260 (1916)). However, causes of action under state law may nonetheless "arise under" federal law for purposes of § 1331 if the four-pronged *Grable* test is met. "[F]ederal jurisdiction over a state law claim will lie if a federal issue is: (1) necessarily raised, (2) actually disputed, (3) substantial, and (4) capable of resolution in federal court without disrupting the federal-state balance approved by Congress."

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[1] 28 U.S.C. § 1441(a) authorizes removal of "any civil action" over which district courts "have original jurisdiction."

Gunn, 133 S. Ct. at 1065 (applying *Grable*). Only a "slim category" of cases satisfy the *Grable* test. *Empire Healthchoice Assurance, Inc. v. McVeigh*, 547 U.S. 677, 701 (2006). Because we conclude that no federal issue has been necessarily raised here, we need not decide whether the other three *Grable* requirements are met.

For a federal issue to be necessarily raised, "vindication of a right under state law [must] necessarily turn[] on some construction of federal law." *Franchise Tax Bd. of State of Cal. v. Constr. Laborers Vacation Trust for S. Cal.*, 463 U.S. 1, 9 (1983). *Grable* presented one of the rare instances where a federal issue was necessarily raised. Grable sued under state law to quiet title. Five years prior to the suit, the Internal Revenue Service ("IRS") seized Grable's land to satisfy a tax deficiency. The IRS then sold that land to the defendant. Grable argued that the IRS did so without giving sufficient notice as required by federal law. Because "whether Grable was given notice within the meaning of the federal statute is . . . an *essential element* of its quiet title claim," the Supreme Court held that the issue of what notice was required under federal law was necessarily raised. *Grable*, 545 U.S. at 315 (emphasis added).

The "classic example," *id.* at 312, of this type of arising under jurisdiction similarly required a determination of federal law as an essential element of the plaintiff's state law claim. In *Smith v. Kansas City Title & Trust Co.*, 255 U.S. 180 (1921), plaintiff sued under a state law which forbade the defendant from investing in illegal

securities. The alleged source of illegality was that the federal bonds purchased by the defendant were unconstitutional (on the theory that Congress did not have the power to issue them). Because the "decision depend[ed] upon the determination of [the constitutional] issue," "which [was] directly drawn in question," federal jurisdiction was proper. *Id.* at 245-46.

By contrast, Regulation SHO is not an element of any of Plaintiffs' claims. The claims, therefore, could be decided without reference to federal law. Plaintiffs alleged a market manipulation scheme and sued exclusively under New Jersey law, including its common law. The District Court, "noting that Plaintiffs do not point to a New Jersey law or regulation which similarly prohibits the type of alleged conduct at issue here," found that the claims were necessarily predicated on the violation of Regulation SHO. *Manning*, 2013 WL 1164838, at *5. We conclude it was improper for the District Court to foreclose the possibility that particular state causes of action could permit recovery solely under state law. It is true that New Jersey's laws are not as robust as federal laws. But we have previously held that even where "[t]here may be some basis to agree with defendants that [plaintiffs'] view of the state law is incorrect and will be so found[, i]t is . . . for the state court to make the determination as to the applicability of its state law." *United Jersey Banks v. Parell*, 783 F.2d 360, 367 (3d Cir. 1986).

Indeed, even under federal law, a claim based on "abusive 'naked' short selling as part of a

manipulative scheme," can be maintained without a predicate violation of Regulation SHO, because such schemes are "always illegal under the general antifraud provisions of the federal securities laws . . . ." 'Naked' Short Selling Antifraud Rule, 73 Fed. Reg. at 61667. Such manipulative schemes may "drive down a company's stock price" and "undermine the confidence of investors," which may, in turn, make investors more "reluctant to commit capital." *Id.* at 61670. If naked short selling can result in a violation of federal general antifraud provisions independently of Regulation SHO, it is difficult to imagine why naked short selling cannot similarly result in a violation of state general antifraud provisions independently of Regulation SHO. Moreover, the Supreme Court of New Jersey, exercising its common-law authority over New Jersey's general securities fraud provisions, has not shied away from deviating from federal law. *See Kaufman v. i-Stat Corp.*, 165 N.J. 94, 97 (2000) ("Even though the theory of fraud on the market has a place in the securities law of this nation, it is a stranger to New Jersey's securities laws. It is also not consistent with the current requirements for a common-law action for fraud in New Jersey.").

As we read the Amended Complaint, no causes of action are predicated *at all* on a violation of Regulation SHO. *Cf. Lippitt v. Raymond James Fin. Servs., Inc.*, 340 F.3d 1033, 1037 (9th Cir. 2003), *as amended* (Sept. 22, 2003) (no jurisdiction even where the complaint "unnecessarily describes the alleged conduct of the defendants in terms that track almost verbatim the misdeeds proscribed by

[federal law]"). For example, Plaintiffs do not plead a violation of Regulation SHO as a predicate violation for purposes of New Jersey RICO. Nor, for the reasons above, do we think Plaintiffs' causes of action necessarily need to be predicated on a violation of Regulation SHO for Plaintiffs to have a chance at recovering under state law.

But even if Plaintiffs' claims were *partially* predicated on federal law, federal law would still not be necessarily raised. *See Christianson v. Colt Indus. Operating Corp.*, 486 U.S. 800, 810 (1988) ("[A] claim supported by alternative theories in the complaint may not form the basis for [federal] jurisdiction unless [federal] law is essential to each.").[2] Where "[p]laintiffs' state [law] RICO claims allege both federal and state predicate acts," no federal question is necessarily raised because a Plaintiff could "prevail upon their New Jersey RICO claims or any of their other state-law claims without any need to prove or establish a violation of federal law." *Fairfax Fin. Holdings Ltd. v. S.A.C. Capital Mgmt., LLC*, No. 06-4197, 2007 WL 1456204, at *2-3 (D.N.J. May 15, 2007) (applying *Christianson* to RICO claims premised on manipulative short selling).

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[2] Although *Christianson* concerned 28 U.S.C. § 1338 (dealing with actions "arising under" the patent laws) rather than § 1331, the Supreme Court noted the "identical language" in the two provisions and applied the "same test" to both. 486 U.S. at 808. *See also Gunn*, 133 S. Ct. at 1064-65 (citing *Christianson* and applying the *Grable* § 1331 analysis to § 1338).

Defendants also assert jurisdiction under § 1331 on the basis of a Frequently Asked Questions ("FAQ") page on the SEC's website. The website is clear from the outset that the FAQ responses are "not rules, regulations, or statements of the [SEC]," nor has the Commission approved them.[3] This website, which we are told refutes Plaintiffs' theory of damages, says that naked short selling does not create "counterfeit shares"—a term Plaintiffs employ liberally in the Amended Complaint. But the phrase "counterfeit shares" does not appear a single time anywhere in the United States Code or the Code of Federal Regulations. Defendants simply cannot carry their burden of establishing jurisdiction based on a "disputed issue of federal . . . law," *Grable*, 545 U.S. at 310, without identifying a particular source of federal law for the judiciary to interpret.

Even if Plaintiffs' theories are factually contradicted by actual rules with the force of law, as the Eighth Circuit thought similar theories were in *Pet Quarters, Inc. v. Depository Trust & Clearing Corp.*, 559 F.3d 772, 781 (8th Cir. 2009) (referencing National Securities Clearance Corporation rules), Defendants would at best be entitled to a preemption defense. "Federal preemption is ordinarily a federal defense to the plaintiff's suit. As a defense, it does not appear on

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[3] Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm (last visited October 24, 2014).

the face of a well-pleaded complaint, and, therefore, does not authorize removal to federal court." *Metro. Life Ins. Co. v. Taylor*, 481 U.S. 58, 63, (1987).[4]

Defendants do not purport to cite a single case regarding § 1331 (other than *Grable* and *Gunn*) in support of their contention that a question of federal law is necessarily raised here. Nonetheless, defendants do cite *D'Alessio v. New York Stock Exchange, Inc.*, 258 F.3d 93, 101-102 (2d Cir. 2001),[5] which held that there was jurisdiction under § 1331 where a court was

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[4] The Eighth Circuit in *Pet Quarters* held that state law claims against SEC-registered clearing agencies for maintaining a program under rules approved by the SEC (which allowed some naked short selling to occur) were all conflict preempted. Although ostensibly recognizing the rule that preemption does not usually give rise to federal-question jurisdiction, the Eighth Circuit held that the *Grable* test was satisfied as the complaint "presents a substantial federal question because it directly implicates actions taken by the Commission . . . ." 559 F.3d at 779. Although Defendants argue that the identity of the defendant is not relevant to the *Grable* inquiry, were we to expand the Eighth Circuit's holding in *Pet Quarters* to all private defendants anytime a plaintiff's claim was uncomfortably juxtaposed with federal regulations, preemption-like arguments would always create federal-question jurisdiction.

[5] Defendants contend *D'Alessio* supports jurisdiction under § 27. But it was plainly decided under § 1331, *id.* at 101, and § 27 was only mentioned in the context of what is now prong three of *Grable* (substantiality) after the necessarily raised issue was resolved. 258 F.3d at 104.

"require[d] . . . to construe federal securities laws," because the plaintiff alleged that the New York Stock Exchange "failed to perform its statutory duty, *created under federal law*, to enforce its members' compliance with those laws." The instant case is distinguishable as Plaintiffs' claims could rise or fall entirely based on the construction of state law.

We conclude that § 1331 does not provide a basis to exercise jurisdiction over Plaintiffs' claims.

B.

Having concluded that there is no arising under jurisdiction here pursuant to § 1331, we must decide whether the exclusive jurisdiction provision in § 27 of the Exchange Act might nonetheless provide a more expansive basis for federal-question jurisdiction. Although Defendants, in advancing this argument, contend that "every circuit court has reached the same conclusion," Appellees' Br. 2, the issue has actually split the two circuits that have most directly addressed it. *Compare Barbara v. N. Y. Stock Exch., Inc.*, 99 F.3d 49, 55 (2d Cir. 1996) ("Our determination that [plaintiff]'s state court complaint did not 'arise under' federal law within the meaning of section 1331 effectively resolves our inquiry under section 27 of the Exchange Act as well. . . . We think that [section 27] plainly refers to claims created by the Act or by rules promulgated thereunder, but not to claims created by state law.")[6] *with Cal. ex rel. Lockyer v.*

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[6] *See also Marel v. LKS Acquisitions, Inc.*, 585 F.3d 279, 280-81 (6th Cir. 2009) ("As the controversy in this case . . .

Dynegy, Inc., 375 F.3d 831, 841 (9th Cir. 2004)[7] ("*Sparta* [*Surgical Corp. v. National Association of Securities Dealers*, 159 F.3d 1209 (9th Cir. 1998)] establishes, however, that the exclusive jurisdiction provision takes the case outside of the rule . . . which otherwise might bar the action if the only jurisdictional provision implicated were [section] 1331. . . . [In *Sparta*] there would have been no jurisdiction predicated solely on [section] 1331. Yet the claim lay 'not under [section] 1331, but under [section 27].'") (internal citations omitted). The Second Circuit recently acknowledged this split in *NASDAQ OMX Grp., Inc. v. UBS Sec., LLC*, No. 13-2657, 2014 WL 5486457, at *17 (2d Cir. Oct. 31, 2014).[8]

We believe the Supreme Court all but answered this question in *Pan American Petroleum Corp. v.*

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was one to enforce a state law claim, this grant of exclusive jurisdiction [in § 27] does not apply. *See Barbara*.").

[7] *Opinion amended on other grounds on denial of rehearing*, 387 F.3d 966 (9th Cir. 2004).

[8] In an "odd[] . . . discuss[ion]," *id.* at *33 (Straub, J. dissenting), on substantially different facts than at issue here, the Second Circuit considered *Sparta* and similar decisions relevant to its analysis of the fourth prong of *Grable* (whether exercising jurisdiction under § 1331 would upset the federal-state balance of judicial responsibilities). Specifically, that court declared that exercising jurisdiction under § 1331 would not upset the federal-state balance given that jurisdiction could be exercised in other circuits under § 27, even though it acknowledged that its own decision in *Barbara* "declined to adopt such a broad reading of [§ 27]"—a decision it was not revisiting. *Id.* at *17.

Superior Court of Delaware In & For New Castle County, 366 U.S. 656 (1961). There, the Supreme Court considered an exclusive jurisdiction provision substantially identical to § 27 of the Exchange Act: § 22 of the Natural Gas Act. *Cf. Tafflin v. Levitt*, 493 U.S. 455, 471 (1990) (noting similarities in the specific language used in § 22 of the Natural Gas Act and § 27 of the Exchange Act, in contrast to other "governing statutes" "[i]n the standard fields of exclusive federal jurisdiction"). "[In § 22 of the Natural Gas Act, 'e]xclusive jurisdiction' is given the federal courts but it is 'exclusive' only for suits that may be brought in the federal courts. Exclusiveness is a consequence of having jurisdiction, not the generator of jurisdiction because of which state courts are excluded." *Pan Am.*, 366 U.S at 664. We see no reason to treat the two provisions differently.

Accordingly, we disagree with the line of Ninth Circuit cases which have held that there can be jurisdiction under § 27 (and other exclusive jurisdiction provisions) even when there is not under § 1331.[9] We note that the Ninth Circuit in its seminal decision in *Sparta* did not consider the Supreme Court's holding in *Pan American*. The incongruity between *Sparta* and *Pan American* was brought squarely before the Ninth Circuit in *Dynegy*.

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[9] *Hawkins v. National Ass'n of Securities Dealers Inc.*, 149 F.3d 330, 331-32 (5th Cir. 1998) (per curiam), although not as explicit as *Sparta* and *Dynegy*, could be read as holding that § 27 can provide subject-matter jurisdiction independently of § 1331. To the extent *Hawkins* so holds, we disagree with it.

At issue in *Dynegy* was the import of § 317 of the Federal Power Act—an exclusive jurisdiction provision substantially identical to both § 27 (which was at issue in *Sparta*) and § 22 (which was at issue in *Pan American*). Although the Ninth Circuit, in a footnote, acknowledged that *Pan American* made clear that such provisions were not "'generator[s] of jurisdiction,'" it nonetheless "fe[lt] bound . . . by *Sparta*'s subsequent interpretation."[10] *Dynegy*, 375 F.3d at 843, n.10. We are not confronted with such a problem, as this Court has faithfully applied *Pan American* to other exclusive jurisdiction provisions. *See Exxon Corp. v. Hunt*, 683 F.2d 69, 74 (3d Cir. 1982) (applying *Pan American* to § 113(b) of the Comprehensive Environmental Response, Compensation and Liability Act).

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[10] Although the Ninth Circuit acknowledged in that footnote that the Supreme Court's holding in *Pan American* actually meant something relevant, the text of its opinion belies that admission: "The *Pan American* court's holding is unremarkable insofar as it held that cases falling *outside* the scope of the exclusive jurisdiction provision are not subject to it." *Dynegy*, 375 F.3d 831 at 843. In reality, *Pan American* stands for the proposition that cases otherwise falling outside the scope of the district courts' *original jurisdiction* are not brought within it by virtue of an exclusive jurisdiction provision. *See In re W. States Wholesale Natural Gas Antitrust Litig.*, 346 F. Supp. 2d 1123, 1130 (D. Nev. 2004). Such is the doctrinal disarray created by *Dynegy* and *Sparta*, that a district court "reluctant[ly] . . . conclu[ded]" that it could not follow the Supreme Court's holding in *Pan American* even with respect to § 22 of the Natural Gas Act—the very provision at issue in *Pan American*. *See Pacificorp v. Nw. Pipeline GP*, No. 10–99, 2010 WL 3199950, at *6 n.3 (D. Or. June 23, 2010) *report and recommendation adopted*, 2010 WL 3219533 (Aug. 9, 2010).

Although it does not appear that any court has expressly relied on *Pan American* to hold that § 27 does not authorize a departure from the *Grable* line of cases, courts have cited *Pan American* in holding that § 27 does not depart from § 1331 in other ways. *See Calvert Fire Ins. Co. v. Am. Mut. Reinsurance Co.*, 600 F.2d 1228, 1231 (7th Cir. 1979) (§ 27 does not prevent state courts from hearing Exchange Act defenses); *Gold v. Blinder, Robinson & Co.*, 580 F. Supp. 50, 54 (S.D.N.Y. 1984) (§ 27 "does not bar a plaintiff from pursuing at its option cognate remedies based entirely upon state law"); *McMahon Chevrolet, Inc. v. Davis*, 392 F. Supp. 322, 324-25 (S.D. Tex. 1975) ("This Court is of the opinion that the exclusive jurisdiction of the federal courts under [§ 27] is like the exclusive jurisdiction of the federal courts under . . . the Natural Gas Act . . . in that such jurisdiction does not bar a plaintiff from pursuing at his option remedies based solely on state law. *Pan Am.*").

We agree with the Second Circuit's holding in *Barbara* that § 27 is coextensive with § 1331 for purposes of establishing subject-matter jurisdiction—the exclusive jurisdiction provision merely serves to divest state courts of jurisdiction.[11] Accordingly, § 27 does not provide an independent basis to exercise jurisdiction over Plaintiffs' claims.

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[11] The District of New Jersey already reached this conclusion in a prior short selling case by relying on *Barbara*. *Fairfax*, 2007 WL 1456204, at *5.

IV.

Having concluded that federal-question jurisdiction is lacking, we will reverse the District Court's March 20, 2013 order, and remand with instructions that the District Court remand this case to the Superior Court of New Jersey.

APPENDIX B

DISTRICT COURT OPINION

NOT FOR PUBLICATION

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

GREG MANNING, et al., Plaintiffs, v. MERRILL LYNCH, PIERCE, FENNER & SMITH, INC. et al., Defendants.	Civil Action No.: 12-4466 (JLL) **OPINION**

This matter comes before the Court by way of the December 31, 2012 Report and Recommendation by the Magistrate Judge Michael Hammer and the objections submitted thereto by Defendants Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., UBS Securities, L.L.C., E*TRADE Capital Marks, L.L.C., National Financial Services, L.L.C. (collectively "Defendants" or "Merrill Lynch").

Upon consideration of the objections submitted by Defendants, the Court ordered Plaintiffs to submit a response, which they did on March 4, 2013 (CM/ECF No. 44). On March 8, 2013, Defendants filed a letter in response to Plaintiffs' submission. (CM/ECF No. 45).[1] For the reasons set forth below, upon *de novo* consideration of the issues objected to by Defendants, the Court DENIES Plaintiffs' motion to remand this matter to the Superior Court of New Jersey.

Plaintiffs allege that Defendants engaged in illegal and manipulative "naked short selling" of Escala Group, Inc. ("Escala Group"), of which they own shares. "'Short selling' is the practice of borrowing shares of stock, selling them and seeking to repurchase those shares at a lower price, returning the lower-priced shares to the lender and keeping the difference as profit." *Fairfax Financial Holdings, Ltd. v. S.A.C. Capital Management, LLC*, Civ. No. 06–4197, 2007 WL 1456204, at *1 (D.N.J. May 15, 2007) (Cavanaugh, J.). The parties do not dispute that "short selling" is a legal practice. As explained by Judge Hammer, however, "'naked short-selling' occurs when traders sell shares they do not own or borrow, or ever intend to own, and never deliver the 'borrowed' securities that they sell.'" (Report and Recommendation, 2–3) (citing *Avenius v. Banc of Am. Sec. LLC*, Civ. No. 06-4458, 2006 WL

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[1] Defendants filed the March 8, 2013, letter without seeking permission from the Court. However, the letter addresses a case decided by the Supreme Court after the filing of Defendants' Objection on which Plaintiffs rely. Accordingly, the Court will consider the letter, as Plaintiffs did not object to same.

4008711 at *1 (N.D. Cal. Dec. 30, 2006); *Capece v. DTCC*, 2005 U.S. Dist. LEXIS 42039, at *1 (S.D. Fla. Oct. 11, 2005)). As noted above, that is the practice with which Plaintiffs premise their Amended Complaint.

In other words, Plaintiffs allege that Defendants sold shares they did not own or borrow, or ever intend to own, which created and circulated unauthorized or counterfeit shares of Escala Group, diluting and artificially depressing their value. During May and December of 2006, Defendants allegedly entered millions of proprietary and customer short sale transactions without having reasonable grounds to believe that the securities could be borrowed and be available for delivery. (Compl.¶ 4).

Plaintiffs commenced this action with the filing of a Complaint on May 8, 2012, in the Superior Court of New Jersey, Law Division, Morris County. (CM/ECF No. 1). On June 7, 2012, Plaintiffs filed an Amended Complaint in the Superior Court of New Jersey. (CM/ECF No. 1). Defendants removed the action to this Court on July 17, 2012. At that time, as now, Defendants contend that removal is proper on two separate grounds: (1) the Court is vested with exclusive jurisdiction under Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa ("Exchange Act" or the "Act"); and (2) the Court is vested with original jurisdiction because Plaintiffs' claims raise, and arise under, federal law. Plaintiffs filed a motion to remand and for an award of attorneys' fees on August 16, 2012. (CM/ECF No. 11).

LEGAL STANDARD

When the magistrate judge addresses motions that are considered "dispositive," such as to grant or deny a motion to dismiss, a magistrate judge will submit a Report and Recommendation to the district court. 28 U.S.C. § 636(b)(1)(A); Fed. R. Civ. P. 72; L. Civ. R. 72.1(a)(2). The district court may then "accept, reject or modify, in whole or in part, the findings or recommendations made by the magistrate [magistrate judge]. The judge may also receive further evidence or recommit the matter to the magistrate with instructions." 28 U.S.C. § 636(b)(1)(C); *see also* L. Civ. R. 72.1(c)(2). Unlike an Opinion and Order issued by a magistrate judge, a Report and Recommendation does not have force of law unless and until the district court enters an order accepting or rejecting it. *United Steelworkers of Am. v. N.J. Zinc Co., Inc.*, 828 F.2d 1001, 1005 (3d Cir. 1987).

The standard of review of a magistrate judge's determination depends upon whether the motion is dispositive or non-dispositive. With respect to dispositive motions, the district court must make a *de novo* determination of those portions of the magistrate judge's Report to which a litigant has filed an objection. 28 U.S.C. § 636(b)(1)(C); Fed. R. Civ. P. 72(b); L. Civ. R. 72.1(c)(2); *see also State Farm Indem. v. Fornaro*, 227 F. Supp. 2d 229, 231 (D.N.J. 2002); *Zinberg v. Washington Bancorp, Inc.*, 138 F.R.D. 397, 401 (D.N.J. 1990) (concluding that the court makes a *de novo* review of the parts of the report to which the parties object).

As previously noted, Defendants object to the Report and Recommendation and argue that it

misconstrues the following: (1) the scope of exclusive jurisdiction under Section 27 of the Exchange Act, 15 U.S.C. § 78aa; and (2) Defendants' argument regarding federal question jurisdiction and the applicability of the Supreme Court's decision in *Grable & Sons Metal Prods., Inc. v. Darue Eng'g & Mfg.*, 545 U.S. 308, 313-14 (2005). Accordingly, the Court will determine de *novo* whether remand is appropriate in light of Defendants' objections. *See In re U.S. Healthcare*, 159 F.3d 142, 146 (3d Cir. 1998).

The party asserting federal jurisdiction by way of removal bears the burden of establishing that federal subject matter jurisdiction exists. *Samuel-Bassett v. KIA Motors Am., Inc.*, 357 F.3d 392, 396 (3d Cir. 2004). A defendant may remove to federal court an action brought in state court if the plaintiff could have filed the complaint within the original jurisdiction of the federal court. 28 U.S.C. § 1441. Courts should construe Section 1441 strictly and resolve all doubts in favor of remand. *Samuel-Bassett*, 357 F.3d at 396. The existence of federal jurisdiction must be decided on the face of the complaint. *Merrell Dow Pharms. v. Thompson*, 478 U.S. 804, 808 (1986) ("[T]he question whether a claim 'arises under' federal law must be determined by reference to the 'well pleaded complaint') (quoting *Franchise Tax Bd. of State of Cal. v. Contru. Laborers Vacation Trust for S. Cal.*, 463 U.S. 1, 9-10 (1983)).

DISCUSSION

Plaintiffs' Amended Complaint alleges that "Defendants substantially injured Plaintiffs while at the same time reaping enormous profits by knowingly and intentionally, creating, loaning and

selling unauthorized, fictitious and counterfeit shares of Escala stock, through various unlawful schemes and devices and by engaging in the unlawful practice of naked short sales." (Compl. ¶ 1). Specifically, the Amended Complaint asserts the following causes of action under state law: (1) violation of New Jersey RICO, N.J.S.A. 2C:41–1 et. seq. predicated on violations of the New Jersey Uniform Securities Law, N.J.S.A. 49:3–49 et seq., theft by taking in contravention of N.J.S.A. 2C:20–2 et seq., and theft by deception counter to N.J.S.A. 2C:20–4; (2) unjust enrichment; (3) unlawful interference with prospective economic advantage; (4) tortious interference with contractual relations; (5) unlawful interference with contractual relations; (6) third party beneficiary claims; (7) breach of covenant of good faith and fair dealing[2]; and (8) punitive and exemplary damages.

Notably, Plaintiffs do not dispute that the alleged unlawful conduct is predicated on a violation of Regulation SHO, 17 C.F.R. § 242.204, promulgated by the Securities and Exchange Commission ("SEC"). Indeed, the Amended Complaint also provides:

> [t]here are certain Defendants who have been fined millions of dollars by the [SEC] and the Financial Industry Regulatory Authority ("FINRA") for their intentional and persistent violation of the rules and regulations governing their unlawful short selling activities. These fines and sanctions, however, have not deterred

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[2] For the sake of completeness, the Amended Complaint designates both the breach of the covenant of good faith and fair dealing, and the third party beneficiary cause of action as "Count Six."

> these Defendants, which view them merely as "pocket change" and the "cost of doing business."

(Compl.¶ 6).

"'Federal courts are courts of limited jurisdiction,' possessing 'only that power authorized by Constitution and statute.'" *Gunn v. Minton*, 133 S. Ct. 1059, 1064 (2013) (quoting *Kokkonen v. Guardian Life Ins. Co. of America*, 511 U.S. 375, 377 (1994)). Generally, federal question jurisdiction may be invoked in two instances: (1) where plaintiffs plead a cause of action created by federal law; and (2) certain state-law claims that implicate significant federal issues. *Grable*, 545 U.S. at 312. Recently, the Supreme Court reiterated that the latter is "a 'special and small category' of cases." *Gunn*, 133 S. Ct. at 1064 (quoting *Empire Healthchoice Assurance, Inc. v. McVeigh*, 547 U.S. 677, 699 (2006)).

As noted above, Defendants contend that removal is proper on two separate grounds: (1) the Court is vested with exclusive jurisdiction under Section 27 of the Exchange Act; and (2) the Court is vested with original jurisdiction because Plaintiffs' claims raise, and arise under, federal law. The Court will address each.

1. The scope of exclusive jurisdiction under Section 27 of the Exchange Act

As an initial matter, no party points to controlling authority on the issue of whether Section 27 of the Exchange Act provides exclusive federal jurisdiction under the specific circumstances raised in this case, namely, where state claims are predicated on a violation of the Exchange Act. Defendants contend that "Plaintiffs' allegations that Defendant violated Regulation SHO's locate

requirement, which, with certain exceptions, compels short sellers to have reasonable grounds to believe that a stock can be borrowed before selling it short" brings those claims squarely within the purview of Section 27. (Defs.' Opp'n. 3).

Plaintiffs rely on *Fairfax*, to argue that the instant matter should be remanded. In that case, the defendants allegedly engaged in the practice of manipulative short selling, by conspiring to devastate the business and reputation of the plaintiff. Specifically, defendants allegedly disseminated corrupt and materially misleading equity research regarding plaintiff's business condition, defamed plaintiff, and harassed the plaintiff's agents and employees. 2007 WL 1456204, at * 1. The plaintiffs in that case filed a complaint in the Superior Court of New Jersey which asserted claims pursuant New Jersey's RICO and common law. The court remanded the case, holding, in relevant part, that "Section 27 does not grant . . . exclusive jurisdiction because [p]laintiffs' action is not an action brought to enforce the securities laws. Rather, Plaintiffs' allegations that Defendants violated provisions of the Exchange Act merely support Plaintiffs' state causes of action." 2007 WL 1456204, at * 5. Therefore, the court concluded that Section 28 saved plaintiffs' New Jersey RICO claims predicated on a violation of the Exchange Act. *Id.*[3]

Section 27 provides, in relevant part, as follows:

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[3] The court reasoned that "Section 28 of the Act preserves state causes of action: 'the rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist in law or equity.'" *Id.* (quoting 15 U.S.C. § 78bb) (alterations omitted).

> The district courts of the United States .... shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

15 U.S.C. § 78aa. "Section 27 of the Exchange Act confers exclusive jurisdiction upon the federal courts for suits brought to enforce the Act or rules and regulations promulgated thereunder." *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 370 (1996). As the case at bar is premised upon and its resolution depends on the alleged violation of a regulation promulgated under the Act, this Court has jurisdiction. *Saks v. Dietrick*, 663 F.3d 1065, 1068 (9th Cir. 2011); *Sparta Surgical Corp. v. NASD. Inc.*, 159 F.3d 1209, 1211-12 (9th Cir. 1998); *see D'Alessio v. NYSE, Inc.*, 258 F.3d 93, 101-02 (2d Cir. 2001). In addition, the *Fairfax* decision is distinguishable here because, unlike *Fairfax*, this case is premised upon enforcement of the federal Exchange Act and corresponding rules and regulations.

2. "Arising Under" Jurisdiction

Defendant argues that there is federal jurisdiction under 28 U.S.C. §§ 1331 and 1337 because Plaintiffs' causes of action depend upon the resolution of a federal issue, namely violation of the Exchange Act and federal regulations, and raise the substantial federal question of whether naked short sales in the National Clearance and Settlement System (the "National System") create "counterfeit" shares. Thus, Defendants maintain that the Report

and Recommendation misconstrues the applicability of the Supreme Court's decision in *Grable*, 545 U.S. at 313-14.

The doctrine of federal "arising under" jurisdiction "captures the commonsense notion that a federal court ought to be able to hear claims recognized under state law that nonetheless turn on substantial questions of federal law, and thus justify resort to the experience, solicitude, and hope of uniformity that a federal forum offers on federal issues." *Grable*, 545 U.S. at 312. The requisite inquiry to determine whether state law claims implicate sufficient federal issues is as follows: (1) does a state-law claim necessarily raise a stated federal issue; (2) is the federal issue actually disputed; (3) is the federal issue substantial; and (4) would entertaining the issue disturb the congressionally approved balance of federal and state judicial responsibilities. *Id.* at 314. Applying that test here, Plaintiffs' claims arise under federal law.

First, the federal issue is necessarily raised by Plaintiffs' claims. Indeed, those claims are predicated on Defendants' alleged naked short sales of Escala stock in violation of SEC Regulation SHO. To prevail on their various state law claims, therefore, Plaintiffs must show that the alleged naked short sales were illegal. As Defendants argue in their Opposition to Plaintiffs' motion to remand, "[i]f, as the SEC has concluded, naked short selling does not create counterfeit shares, Plaintiffs have no cognizable injury, and their claims must be dismissed." (Defs.' Opp'n. 30-31). It bears noting that Plaintiffs do not point to a New Jersey law or

regulation which similarly prohibits the type of alleged conduct at issue here.

Second, the federal issue is disputed. Defendants argue that "Plaintiffs' claims in this case are impossible to adjudicate without determining whether Plaintiffs are correct that so-called 'naked' short selling creates 'counterfeit shares.' This is because Plaintiffs' only basis for damages is their claim that the alleged 'counterfeit shares' diluted the value of their 'legitimate' Escala shares." (Def.'s Obj. 8). The viability of Plaintiffs' claims turns on that issue and Plaintiffs seek damages incurred as a result of the dilution and artificially depressed value of their shares.

In addition, the federal issue is substantial. *See Empire HealthChoice Assurance, Inc. v. McVeigh*, 574 U.S. 677, 700-01 (2006). Resolution of Plaintiffs' claims depends on the disputed issue. Determination as to whether the alleged naked short selling creates phantom shares would also impact subsequent lawsuits. Further, the issue is important to the federal system as a whole. Recently, in *Gunn v. Minton*, the Supreme Court considered whether a plaintiff's legal malpractice claim, which involved the viability of an experimental-use argument in an underlying patent case, arose under federal patent law. Expounding on the substantiality component of the *Grable* inquiry, the Supreme Court wrote: "it is not enough that the federal issue be significant to the particular parties in the immediate suit; that will *always* be true when the state claim 'necessarily raises' a disputed federal issue, as *Grable* separately requires. The substantiality inquiry under *Grable* looks instead to the importance of the issue to the federal system as a whole." 133 S.Ct. at 1066. The

Court in *Gunn* reasoned that the federal issue was not substantial because the federal patent question in that case was hypothetical "due to the backward-looking nature of a legal malpractice claim." *Id.* at 1066–67. Similarly, allowing state courts to resolve the case would not "undermine the development of a uniform body of patent law." *Id.* (alterations and quotations omitted).

It is worth noting that the issuance of the Report and Recommendation in this matter preceded the *Gunn* and, accordingly, Judge Hammer did not have the benefit of that decision. In this case, Defendants argue that "the existence of 'counterfeit shares' presents a substantial issue of federal law because it requires analysis of the regulations governing the federally sanctioned system for securities trading. Indeed, if naked short selling did create 'counterfeit shares,' as Plaintiffs claim—and the SEC has denied—then the entire federal system for short selling would be called into question." (Def.'s Obj. 9). Plaintiff, on the other hand, draws a parallel between the current New Jersey RICO claims and the attorney malpractice claim in *Gunn* to argue that the violation of Reguation SHO constitutes a "case within a case." (Pls.' Resp. 9). Therefore, they argue, "[a]pplying *Gunn* to the case at bar, there is an insufficient link in Plaintiff's state RICO claims to the substantial federal issues of law. Simply because Defendants claim that there are important issues to the federal system at stake does not make it true . . . ." (Pls.' Resp. 10).

In response, Defendants urge that Plaintiffs' theory threatens the uniform administration of the federal securities scheme. "To win relief, Plaintiffs must prove violations of Regulation SHO and other

federal regulations. In the absence of federal jurisdiction, such claims would be subject to state courts, not uniform federal adjudication. Plaintiffs must also prevail on their 'counterfeit share' theory to show any injury under their Complaint." (Defs.' Resp. 2). In addition, the theory of relief throws into question the entire federal scheme for regulating short selling. *Id.* "Specifically, if Plaintiffs prevail on this point, certain aspects of short selling explicitly permitted under the federal regulations would be subject to state liability, raising clear problems for the decisions made by federal regulators and the uniformity of the federal regulatory scheme." *Id.*

The Court finds the instant case distinguishable from the backward looking malpractice "case within a case" at issue in *Gunn*. Rather, as Defendants argue, other federal courts have found that the existence of "counterfeit shares" raises a substantial federal issue. *Pet Quarters, Inc. v. Depository Trust & Clearing Corp.*, 545 F. Supp. 2d 845, 848-49 (E.D. Ark. 2008); *Capace v. DTCC*, Civ. No. 00–5404, 2005 WL 4050118, at *8 (S.D. Fla. Oct. 11, 2005).

Plaintiffs urge that relevant case law demonstrates that "cases removed to federal court have consistently been remanded where the predicate acts alleged under state RICO statutes include violations of the federal securities laws, such as the Exchange Act." (Pls.' Mot. 1, 9-11) (citing *Fairfax*, 2007 WL 1456204, at *5 (D.N.J. May 15, 2007); *Meinders v. Fefco Sec. Inc.*, 865 F. Supp. 721, 723 (D. Colo. 1994); *Horowitz v. Marlton Oncology, P.C.*, 116 F. Supp. 2d 551, 554–556 (D.N.J. 1999)). In the context of a previous motion to remand, this Court has previously interpreted the two District of New Jersey cases cited by Plaintiffs and explained

that it declines to permit those decisions to "stand for the broad proposition that no federal interest, however important, can support federal jurisdiction if it is brought through the vehicle of state law." *Ortiz v. University of Medicine & Dentistry of New Jersey*, Civ. No. 08–2669, 2009 WL 2194782, at *4 (D.N.J. Mar. 18, 2009). In this case, the Court finds that the Amended Complaint sets forth a substantial question of federal law. Accordingly, the third prong of the *Grable* test is satisfied. 545 U.S. at 314.

Finally, entertaining the issue would not disturb the congressionally approved balance of federal and state judicial responsibilities. The instant matter primarily involves the issue of whether the complained of conduct is consistent with Defendants' obligations under the Exchange Act and regulations promulgated thereunder. *See Friedlander v. Troutman, Sanders, Lockerman & Ashmore*, 788 F.2d 1500, 1504 (11th Cir. 1986) (noting that "[t]he comprehensive scheme of statutes and regulations designed to police the securities industry is indicative of a strong federal interest."). In addition to the fact that the Court determined above that it has exclusive jurisdiction under Section 27 of the Exchange Act, it is worth reiterating that the decisions of other courts indicate that Congress intended federal courts to have exclusive jurisdiction of violations of the Exchange Act and rules and regulations promulgated thereunder. *Saks v. Die trick*, 663 F.3d 1065, 1068 (9th Cir. 2011); *D'Alessio v. NYSE, Inc.*, 258 F.3d 93, 101-02 (2d Cir. 2001); *Sparta Surgical Corp. v. NASD Inc.*, 159 F.3d 1209, 1211-12 (9th Cir. 1998). This case does not involve a specific body of law in which New Jersey has a similar interest, such as regulating professionals

within that jurisdiction. *See Gunn*, 2013 WL 610193, at * 10. Indeed, Plaintiffs do not point to a violation of New Jersey's securities law. In the case at bar, the essence of the Amended Complaint is that violation of Regulation SHO and other federal regulations gave rise to a number of state claims. Thus, this case is distinguishable from *Fairfax* which involved allegations of lawful short selling in conjunction with dissemination of corrupt and materially misleading equity research regarding the plaintiff's business condition, defamation, and harassment of plaintiff's agents and employees. Defendants argue that "so long as parties like Plaintiffs choose to assert their 'counterfeit shares' theory and other securities arguments in nominal state-law claims such as the ones presented here, federal courts would never have the opportunity to rule on them." (Defs.' Resp. 3). Accordingly, the instant matter would not disturb the balance between state and federal judicial responsibilities.

CONCLUSION

Therefore, for the reasons stated above, upon *de novo* consideration of the portions of the Report and Recommendation to which there were objections, the Court finds that there is federal jurisdiction over the instant matter. Accordingly, the Court DENIES Plaintiffs' motion to remand.

An appropriate Order accompanies this Opinion.

Dated: 3/18/13

/s/ Jose L. Linares
Jose L. Linares
United States District Judge

APPENDIX C

COURT OF APPEALS ORDER DENYING REHEARING

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 13-3693

GREG MANNING; CLAES ARNRUP; POSILJONEN AB; POSILJONEN AS; SVEABORG HANDEL AS; FLYGEXPO AB; LONDRINA HOLDING LIMITED,

Appellants

v.

MERRILL LYNCH PIERCE FENNER & SMITH, INC.; KNIGHT CAPITAL AMERICAS, a/k/a Knight Equity Markets L.P.; UBS SECURITIES LLC; E TRADE CAPITAL MARKETS LLC; NATIONAL FINANCIAL SERVICES LLC; CITADEL DERIVATIVES GROUP LLC; JOHN DOES 1-10 (names being fictitious); ABC COMPANIES 1 10
(names being fictitious), jointly, severally or in the alternative, individually

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SUR PETITION FOR REHEARING

Present: McKEE, Chief Judge, RENDELL, AMBRO, SMITH, FISHER, JORDAN, GREENAWAY, JR., VANASKIE, SHWARTZ, KRAUSE, and SLOVITER,* Circuit Judges

The petition for rehearing filed by appellees in the above-entitled case having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court en banc, is denied.

BY THE COURT,

s/ D. Brooks Smith
Circuit Judge

Dated: January 15, 2015

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* The vote of the Honorable Dolores K. Sloviter, Senior Judge of the United States Court of Appeals for the Third Circuit, is limited to panel rehearing.

APPENDIX D

AMENDED COMPLAINT

NEAL H. FLASTER L.L.C.
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Tel. No.: 973-822-7900
Attorney for Plaintiff
Greg Manning. et al

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CIVIL DIVISION

GREG MANNING; CLAES ARNRUP; POSILJONEN AB; POSILJONEN AS; SVEABORG HANDEL AS; FLYGEXPO AB; and LONDRINA HOLDING, LTD.,

Plaintiffs,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.; KNIGHT CAPITAL AMERICAS, L.P., formerly known as KNIGHT EQUITY MARKETS L.P.; UBS SECURITIES, L.L.C.;

SUPERIOR COURT OF NEW JERSEY LAW DIVISION: MORRIS COUNTY

DOCKET NO.: L-1173-12

Civil Action

E TRADE CAPITAL MARKETS L.L.C.; NATIONAL FINANCIAL SERVICES, L.L.C.; CITADEL DERIVATIVES GROUP, L.L.C.; JOHN DOES 1-10 (names being fictitious); and ABC COMPANIES 1-10 (names being fictitious), jointly, severally or in the alternative, individually

Defendants.

AMENDED COMPLAINT AND JURY DEMAND

Plaintiffs Greg Manning ("Manning"), residing at 4 Whitfield Court, Boonton Township, New Jersey 07932; Claes Arnup, residing at Hans Michelsensgatan 9, 11th floor, Malmo, Sweden, Posiljonen AB ("Posiljonen AB"), with its principal place of business located at Box 537, S-201 25 Malmo, Sweden; Posiljonen AS ("Posiljonen AS"), with its principal place of business located at Koebmagergade 2, DK-1050 Copenhagen, Denmark; Flygexpo AB ("Flygexpo"), with its principal place of business located at Box 321, S-72107 Vaesteraas, Sweden; Sveaborg Handel AS ("Sveaborg"), with its principal place of business located at Postboks 5098, Majorstua, —0301 Oslo, Norway; and Londrina Holding Ltd. ("Londrina"), with its principal place of business located at Boit Postal 260, L-2012 Luxemburg by way of complaint say:

NATURE OF ACTION

1. This is an action to recover damages incurred as a result of Defendants' massive manipulation of the market for the price of the common stock of Escala Group, Inc. ("Escala")[1] beginning May 9, 2006 ("Relevant Period I") through May 12, 2006 and again from December 1, 2006 through January 9, 2007 ("Relevant Period II"). As set forth herein, Defendants knowingly and intentionally engaged in the unlawful practice of naked short sales of Escala stock by creating, loaning and selling unauthorized, fictitious and counterfeit shares through various unlawful schemes and devices for the purpose of reaping enormous profits.

2. Defendants' unlawful conduct, occurring within the context of a pervasive and long- standing pattern of naked short selling of securities, constituted an unlawful form of market manipulation in violation, inter alia, of the New Jersey Racketeering Influenced and Corrupt Organization Act, N.J.S.A. 2C:41-1 et seq., the New Jersey Uniform Securities Act, N.J.S.A. 49:3-49 et seq., and various other New Jersey statutes and common law causes of action, including but not limited to theft by taking, theft by deception, unjust enrichment, unlawful interference with Plaintiff's economic advantage, tortious interference with Plaintiff's prospective economic advantage, breach of contract and breach of the covenant of good faith and fair dealing.

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[1] Escala is now known as Spectrum Group International, Inc.

3. To perpetrate this massive manipulation of the market price of Escala shares of stock, Defendants inter alia, designed their schemes and Employed their devices while engaged in a pattern of racketeering activity that resulted in their entering millions of proprietary and customer short sale transactions during the Relevant Period(s), while lacking reasonable grounds to believe that the securities could be borrowed and be available for delivery.

4. By undertaking the unlawful naked short selling of Escala stock, Defendants inter alia, increased the pool of tradable shares by electronically manufacturing fictitious and unauthorized phantom shares and using non-registered Escala shares to dilute the fixed percentage of the Plaintiffs' stock; however, in so doing, this caused the shares to dramatically decline in value with Defendants then selling or loaning these shares, receiving significant profits and fees for their unlawful actions. Thereafter, Defendants implemented a sophisticated scheme to conceal and cover-up their illegal conduct to avoid detection.

5. Defendants have been fined hundreds of thousands of dollars or more by regulatory agencies for their intentional and persistent violation of rules and regulations governing unlawful naked short sales of securities. However, these fines and sanctions have failed to deter Defendants from continuing to engage in business "as usual", viewing these sanctions as merely "pocket change" and the "cost of doing business". See Exhibit A, annexed hereto.

6. Plaintiffs seek entry of judgment against

each Defendant for statutory treble damages pursuant to the New Jersey Racketeering Influenced and Corrupt Organization Act, N.J.S.A. 2C:41-1 et seq., attorney's fees, compensatory damages, punitive damages, interest and costs of suit.

PARTIES AND NON PARTY PARTICIPANTS

A. Plaintiffs.

7. Plaintiff Manning, the owner of approximately 2.1 million shares in the Escala Group, Inc. ("Escala") during the Relevant Periods was a resident of Morris County and State of New Jersey at that time and currently resides at 4 Whitfield Court, Boonton Township, County of Morris and State of New Jersey.

8. Plaintiff Arnup, the owner of approximately 10,000 shares of stock in Escala during Relevant Period 1, is an individual residing at Hans Michelsensgatan 9, 11th floor, Malmoe, Sweden.

9. Plaintiff Posiljonen AB, the owner of approximately 60,000 shares of stock in Escala during the Relevant Period(s), is a company with its principal place of business located at Box 537, S-201 25 Malmoe, Sweden.

10. Plaintiff Posiljonen AS, the owner of approximately 13,100 shares of stock in Escala during the Relevant Period(s), is a company with its principal place of business located at Koebmagergade 2, DK-1050 Copenhagen, Denmark.

11. Plaintiff Flygexpo AB, the owner of approximately 30,000 shares of stock in Escala during the Relevant Period(s), is a company with its principal place of business located at Box 321,

S-72107 Vaesteraas, Sweden.

12. Plaintiff Sveaborg Handel AS, the owner of approximately 55,000 shares of stock in Escala during the Relevant Period(s), is a company with its principal place of business located at Postboks 5098, Majorstua,—0301 Oslo, Norway.

13. Plaintiff Londrina Holding Ltd., the owner of approximately 110,000 shares of stock in Escala during the Relevant Period(s), is a company with its principal place of business located at Boit Postal 260, L-2012 Luxemburg.

B. Entity Defendants.

14. Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"), its subsidiaries, affiliates, successors or assigns, is a business corporation organized under the laws of Delaware that conducts business in or that affects New Jersey, is authorized to do business in New Jersey and has offices located at 1300 Merrill Lynch Drive, Pennington, New Jersey.

15. Defendant Knight Capital Group, Inc., ("Knight"), its subsidiaries, affiliates, successors or assigns, including but not limited to Knight Capital Americas, L.P., formerly known as Knight Equity Markets, L.P. ("Knight Equity"), is a business corporation organized under the laws of Delaware that conducts business in or that affects New Jersey, is authorized to do business in New Jersey and has its principal place of business located at 545 Washington Blvd., Jersey City, New Jersey.

16. Defendant UBS Securities, L.L.C. ("UBS"), its subsidiaries, affiliates, successors or assigns, conducts business in or that affects New

Jersey and has offices located at 480 Washington Blvd., Jersey City, New Jersey.

17. Defendant E*Trade Capital Markets, L.L.C. ("E*Trade"), its subsidiaries, affiliates, successors or assigns, is a subsidiary of E*Trade Financial Corporation, which conducts business in or that affects New Jersey and has offices located at Harborside Financial Center, 501 Plaza 2, 34 Exchange Place, Jersey City, New Jersey.

18. Defendant National Financial Services, L.L.C. ("National Financial"), its subsidiaries, affiliates, successors or assigns, conducts business in or that affects New Jersey and has offices located at 1000 Plaza, Jersey City, New Jersey.

19. Defendant Citadel Derivatives Group, L.L.C., its subsidiaries, affiliates, successors or assigns conducts business in or that effects New Jersey and has its offices located at 131 South Dearborn Street, #3100, Chicago, Illinois.

20. Defendants ABC Companies 1-10 (names being fictitious) are such companies or entities whose identities are unknown who acted individually or collectively with one or all of the other Defendants: a) to cause Plaintiffs to suffer financial harm; and b) to form, operate or manage an enterprise for the purpose of engaging in unlawful activity affecting trade or commerce in New Jersey , including but not limited to such activity which serves as the basis for relief under the New Jersey Racketeering Influenced and Corrupt Organization Act, N.J.S.A. 2C:41-1 et seq.; and c) to operate or manage an enterprise involved in unlawful activities affecting trade or commerce in New Jersey.

C. Non- Entity Individual Defendants.

21. Defendants John Does 1-10 (names being fictitious) are such persons whose identities are unknown who acted individually or collectively with one or all of the other Defendants to cause Plaintiffs: a) to suffer financial harm; and b) through a pattern of illegal racketeering activity, operate or manage an enterprise engaged in activities affecting trade or commerce in New Jersey, including but not limited activities which serves as the basis for relief under the New Jersey Racketeering Influenced and Corrupt Organization Act, N.J.S.A. 2C:41-1 et seq.

D. Non-party Participant(s).

22. Non-party Participant Escala had its principal place of business located at Passaic Avenue, in the Township of West Caldwell, County of Essex and State of New Jersey during the Relevant Period(s) in issue.

FACTS COMMON TO ALL CLAIMS

A. Background

1. Short Selling as a Lawful Trading Strategy

23. In a typical legal short selling transaction, a party known as a "Short Seller" speculates that the price of a stock will decline, and seeks to profit from that expected decline. To accomplish this, the Short Seller locates and then borrows shares of the subject company's stock from another shareholder in a transaction typically arranged by the broker dealer, and sells those borrowed shares on the open market at the existing price. The Short Seller completes the transaction, i.e., covers its short position, by replacing the shares it borrowed by purchasing the

subject company's stock at a later date, and returning the borrowed shares back to the lender. If the Short Seller's speculation that the stock price will decline is correct, the Short Seller will earn as profit the difference between the higher price at which it sold the borrowed shares and the lower price at which it subsequently replaced them. As an illustrative example, a Short Seller speculates that Stock X is currently overvalued at $50/share, and expects the share price to decline. The Short Seller (who does not own Stock X) borrows 100 shares of Stock X, and sells those shares on the open market at the existing $50/share price. The borrowed shares are delivered to the purchaser to complete the proper settlement of the short sale. If the stock price later falls to $45/share, and the Short Seller purchases 100 shares of the stock to replace the shares the short seller borrowed at $50 per share, the short seller has earned $5/share, minus any fees, commissions and/or interest it incurred in completing the transaction. If the stock is never borrowed then the profit is significantly greater by avoiding the borrowing fees, commissions and interest. If the subject company files for bankruptcy the short seller will never replace the shares that were sold.

24. When conducted in accordance with securities and other laws and regulations, short selling is a legal and accepted trading strategy. However, a critical requirement of a *lawful* short sale is that the Short Seller first makes an affirmative or reasonable determination that the shorted shares are available and the broker actually borrows or otherwise obtains the stock it sells. Indeed, securities laws and regulations require a

Short Seller to borrow the stock it sold and deliver that borrowed stock within three days of the short sale (the "Settlement Date"). This settlement cycle is known as "T+3". T+3 means that when a trade occurs, the participants to the trade deliver and pay for the security at the clearing agency three settlement days after the trade is executed so the brokerage firm can exchange those funds for the securities on that third settlement day.

2. Naked short sales of stock as an unlawful trading strategy used to manipulate the market in which securities are traded

25. In a "naked" short sale, the seller does not own, and does not borrow or arrange to borrow the securities in time to make delivery to the buyer within that standard T+3 Settlement Date. As a result, the seller fails to deliver the securities to the buyer when the delivery is due. If the Short Seller never borrows or otherwise obtains the stock it sold short, the Short Seller cannot convey or deliver authorized and legitimate stock to the purchaser. In those instances in which a Short Seller fails to borrow or otherwise obtain the stock it sold short, the purchaser is not precluded from completing the sale and obtaining the purchased stock.

26. Today, most settlements of securities trades are conducted electronically through a central depository, known as the Depository Trust and Clearing Corporation and its primary subsidiary, National Securities Clearing Corporation (collectively referred to herein as the "DTCC"), which accounts for the buying and selling of securities through electronic book entries (rather than transfer

of physical stock certificates).

27. In a typical securities transaction, the DTCC's electronic trading records reflect that the buyer "owns" the shares, and that the seller "owes" the purchased shares, which the seller is required to deliver by the Settlement Date. In a short sale, the DTCC still electronically transfers to the buyer the stock it purchased *even if the seller fails to deliver the shares it "owes" to the DTCC* ("Fail"). If the Short Seller Fails to deliver the stock it owes to the DTCC, the Short Seller has, in effect, electronically created and conveyed an unauthorized, fictitious and/or phantom share of stock to the buyer because the DTCC credits the buyer with owning shares that did not previously exist. The newly created shares are counterfeit shares because they were not authorized or issued by the company or registered for sale by the company with either the SEC or the market exchange on which the shares trade. These unauthorized, counterfeit shares, are created electronically by the Short Seller through an illegal short sale of a stock that the Short Seller did not own, deliver and/or intend on possessing in order to complete the settlement of the short sale.

28. In 2005, in response to pervasive manipulative conduct in the unlawful naked short sales of securities, the Securities and Exchange Commission ("SEC") adopted Regulation SHO ("Reg SHO"), 17 C.F.R. § 242.204. The general purpose of Reg SHO is to establish uniform "Locate" and "Close-Out" requirements and prevent unlawful naked short selling, in which market participants like the Defendants, sought to obtain illicit profits by selling or loaning stock at artificially depressed prices that they did not own, never intended to borrow or locate

for delivery to buyers and close-out by settling their trades.

29. The SEC articulated the pernicious effects of naked short selling on the securities markets, stating that:

> ...we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that may have been priced differently. Moreover, sellers that fail to deliver securities on trade settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that deliberately and improperly depress the price of a security.
>
> In addition, many issuers and investors continue to express concern about extended fails to deliver in connection with "naked" short selling. To the extent that large and persistent fails

> to deliver might be indicative of manipulative "naked" short selling, which could be used as a tool to drive down a company's stock price, fails to deliver may undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct. In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding large and persistent fails to deliver. Any unwarranted reputational damage caused by large and persistent fails to deliver might have an adverse impact on the security's price...

30. In November of 2007, former SEC Chairman Harvey Pitt derided the practice of naked short selling stating: "Phantom shares created by naked shorting are analogous to counterfeit money." Similarly, during a February 14, 2008 Senate Banking Committee Hearing, Senator Robert Bennett commented that through naked short selling it is becoming "increasingly...easier in this electronic world to give you counterfeit shares." The SEC also reaffirmed its ". . . zero tolerance for abusive naked short selling" by strengthening investor protection. Indeed, the SEC, which regulates federal securities laws that are substantially similar to New Jersey's Securities Act, has explicitly stated that selling stock short and failing to deliver shares at the time of settlement with the purpose of driving down the security's price" constitutes a "manipulative activity" that "in general, would violate various securities laws." *See*

www.sec.gov/spotlight/keyregshoissues.htm; *See also* SEC Release No. 34-.57511, p.3, File No. S7-08-08 (Mar. 17, 2008).

31. Naked short selling exacerbates volatility in the securities markets and damages bona fide shareholders of a company because it floods the market with, unauthorized, fictitious and/or counterfeit shares or entitlements, thereby diluting the value of each legitimate share of stock, diluting the shareholder's right to a fixed percentage of ownership of the company and diluting the shareholder's voting rights. Naked short selling is intended to deliberately depress the price of a security in order to maximize the profit that is made based on the difference between the price of the stock when it was sold and the price of the stock that is required to be delivered on the Settlement Date.

32. The DTCC is a corporation formed for the clearance and settlement of securities transactions, which is undertaken through a series of electronic systems. It was created in 1974 for, inter alia, the "prompt and accurate clearance and settlement of securities transactions" as "necessary for the protection of investors." Since 1999, the DTCC has controlled virtually all of the U.S. trade clearance and settlement processing of real stock issued by corporations that is held in brokerage accounts and did so during the relevant periods at issue in the within Complaint.

33. In 1981, further efforts were made to increase the speed of the settlement trade process through the advent of the DTCC stock borrow program by the DTCC within its overall system. That program created a massive lending pool of

shares from brokers' client margin accounts (i.e., brokerage accounts in which the broker lends the customer cash to purchase securities, which are securitized by both securities and cash), which facilitated securities trading. For example, if a prime broker is unable to deliver stock it sold within the T+3 Settlement Date, the prime broker could obtain shares to provide to the purchaser from the DTCC borrowing pool, allowing the trade to clear. When operated properly, the prime broker who sold the stock will replace the shares it owes to the DTCC. But, as set forth in detail herein, the Defendants violated the trading rules and regulations requiring that they actually deliver shares they owe to the DTCC to settle short sale transactions.

34. The Defendants, who are owners of the DTCC, have significant involvement and communication with, as well as influence over, the DTCC. For example, Defendants act as "DTCC member clearing firms," meaning that they are informed by the DTCC of the clearing and settling of trades and purportedly they assure that paperwork associated with a securities transaction is accurate. Moreover, Defendants, as prime brokers, play an integral role in short sale securities transactions; among other things, Defendants are responsible for locating shares of the shorted stock, borrowing the short stock, and delivering the shares by the T + 3 Settlement Date.

35. Defendants' illegal short selling activity has not been limited to Escala shares of stock, but is part of an ongoing pattern of unlawful naked short selling of securities of other companies. Because naked short selling was and is enormously lucrative

to the Defendants, the relatively minor sanctions and penalties assessed against them (when one considers the magnitude of the money directly connected to naked short selling) have failed to stop or even deter Defendants' from continuing to engage in such unlawful conduct. Defendants have a long and well documented history of being "recidivist" offenders of fraud and stock manipulation statutes and as one Court recently held, civil penalties and disgorgement even as high as $295 million are considered by the investment community to be merely, a "mild and modest cost of doing business."

B. The nature and scope of Defendants' unlawful scheme to manipulate Escala stock

36. Many of the Defendants unlawful acts and/or omissions are currently known only by them and are contained in documents and electronic records which they exclusively possess, control and maintain. However, Plaintiffs are aware of certain specific facts and circumstances that when analyzed within the context of publicly available records, clearly demonstrate a pattern of unlawful conduct.

37. Upon information and belief, during the Relevant Period(s), Defendants manipulated the price of Escala's common stock through a pattern of naked short selling by:

a) creating and/or using unauthorized counterfeit shares to increase the pool of tradable common stock which operated to dilute the shares owned by Plaintiffs;

b) selling and/or loaning unauthorized and counterfeit shares, thereby enabling Defendants to reap millions of dollars in

unlawful profits and fees while simultaneously injuring plaintiffs; and thereafter;

c) implementing a sophisticated scheme to conceal and cover up their unlawful conduct.

38. On the close of business on May 8, 2006, the share price of Escala stock was $32 a share. Its share value declined to $12.23 at the close of business on May 9, 2006, a 62% drop in value as the result of large scale selling of unlawful and counterfeit short shares which were neither borrowed nor delivered by Defendants to complete a legal sale and illegal trades used for the purpose of manipulating Escala's share price. The share value of the Escala stock continued to decline until it reached $4.00 a share on May 12, 2012.

1. Defendants' creation and/or use of fictitious and unauthorized phantom shares of Escala stock

39. Upon information and belief, Defendants traded in their own proprietary accounts and/or loaned Escala stock to their clients and others to complete short sales at times when Defendants neither possessed, nor had any intention of obtaining sufficient authorized stock to cover these transactions.

40. When a customer or prime broker seeks to sell a stock short, the prime broker or customer must first determine whether there are shares available to be borrowed. When the broker does not itself have shares available to borrow, the prime broker must ask other prime brokers whether they have shares available to lend and deliver to complete the short

sale. When one prime broker affirmatively states that it has shares available to lend and deliver, that statement is referred to as giving a "Locate."

41. Upon information and belief, Defendants gave and received false "Locates", knowing that they would not likely have to deliver the located shares if requested, thereby artificially increasing the pool of tradable Escala shares. Many of these same Defendants improperly provided Locates for Escala securities on the same dates for which they were failing to deliver Escala securities (i.e., Defendants were saying they had Escala securities available to lend to facilitate additional short selling at the same time they did not have sufficient Escala securities to cover past sales).

42. Upon information and belief, Defendants claimed to receive Locates from other Defendants (or non-party banks) on dates when those other Defendants (or non-party banks) did not have sufficient Escala securities to cover the alleged Locates and accepted Locates they knew were unreliable. Giving these false Locates allows the counter-party to the short sale transaction to complete the unauthorized sale and generate commissions without having to actually borrow the stock and incur borrowing costs.

43. When a Short Seller fails to deliver stock by the Settlement Date, the DTCC system indicates that a "Fail" occurred. Under DTCC rules, only the purchaser (or the Defendant prime broker representing it) has the ability to force the short seller to deliver the shares and clear out the "Fail" positions. Defendants, however, by implicitly agreeing not to require each other to clear out "Fails"

and instead, permitted "Fail" transactions to remain unfulfilled indefinitely, facilitated naked short sales by eliminating the need for a Defendant to actually locate Escala shares before loaning or selling Escala shares in conjunction with a short sale. It also deceives the market, the regulators and keeps the stock off of the Reg. SHO list, thus avoiding additional regulatory scrutiny and enforcement.

2. Defendants' unlawful and/or lending of unauthorized and fictitious shares of Escala stock

44. Each of the Defendants maintain their own proprietary accounts from which they conduct stock transactions on their own behalf. Analysis of the trading of Escala stock demonstrates patterns of trading that do *not* correlate to the activity recorded in the DTCC's electronic trading records and therefore, reflect a material deviation from various stock indices indicative of illegal naked short selling. Although there were significant amounts of Escala stock traded by the Defendants during the Relevant Periods, since the DTCC's records show little if any change in the Defendants' net position, the shares traded were not authorized or legitimate but were rather, counterfeit, fictitious and unauthorized.

3. The Events of May 2006 (Relevant Period I)

45. In May 2006, there were 9,037,738 shares of Escala stock on deposit at the DTCC where the actual shares issued by Escala in the public float are accounted for. In practice, the DTCC acts as a "bank" for the shares of publicly traded corporations held in brokerage accounts, with the DTCC accounting for the transfers of shares between firms.

There were at least 1.9 million shares of Escala stock held in cash or non marginable accounts, which could not be loaned out for short sales and therefore, could not be sold in the market. This reduced the actual public float at the DTCC to 7,137,738 million shares and of these shares, there were 5,615,754 million shares already shorted in May 2006, leaving only 1,521,904 million shares available in the public float to settle long and short sales.

46. Approximate Number of Escala shares available to settle trades in May 2006.

Settlement Date	***5/5/2006***	***5/12/2006***	***5/19/2006***
Shares on deposit with DTCC	9,037,738	9,037,738	9,037,738
Non-Shortable Shares	1,900,000	1,900,000	1,900,000
Short Interest	4 859,221	5.615,754	5,615,754
Approx. Shares Available	**2,278,517**	**1,521,984**	**1,521,984**
Escala's Trade Volume			
Shares Traded Between Periods		8,349,565	66,697,503
Shares traded on May 9th		6,944,513	

47. In May 2006, reported short interest was 5,615,754 shares or approximately 62% of the 9.1 million shares in the public float. DTCC records show that the public float remained consistent from May 2006 through January 2007 at less than 9.1 million shares. In essence, when the 1.9 million shares that were in the known accounts that could not be shorted were taken into consideration, 79% of the remaining shares on deposit at the DTCC were already shorted. The real shares issued by Escala that were in the public float, less established short

positions and shares in friendly hands in non-shortable accounts totaled approximately 1.5 million shares.

48. In May 2006, there was a significant increase in marketplace volume of Escala stock to over 97 million shares verses April's marketplace volume of 2.7 million shares, an increase of 35.5 times the previous monthly volume. The May marketplace volume of 97 million shares was a rotation of 10.8 times all of Escala's shares on deposit at the DTCC or averaging a turnover of the DTCC shares every two days for the month. The majority of this volume, 91,002,350 shares or 93% of the May 2006 volume, transacted in just 11 days, which equates to the entire number of shares on deposit turning over, every 1.1 days during this 11 day period. The 9.1 million shares on deposit at the DTCC were, in theory, turned over ten times in these 11 days. Moreover, shares in the real available float (shares on deposit at the DTCC less shares on deposit in non shortable accounts less short interest totaling approximately 1.5 million shares) turned over approximately 60 times in this 11 day period.

49. The incongruence between the number of Escala shares traded and the number of shares on deposit with the DTCC available to be traded is indicative of Defendants' unlawful naked short selling of Escala stock. Based on the movement of real shares at the DTCC, it would be impossible to trade 91 million shares in the 11 days in May 2006, as these transactions could not have been short sales because there were not significant numbers of shares to short.

50. In the months preceding May 2006; Escala shares of stock were failing to deliver in small quantities at the National Securities Clearing Corporation ("NSCC"), which indicated that there were few shares available to borrow to complete short sale settlements. Fails as a percentage of short interest were relatively small in 2006 and averaged 1.6% from January to April 2006. By May 10, 2006, the short interest reporting date, fails to deliver increased to 1,464,623 shares from a prior two day fail to deliver level of 52,229 shares. Fails as a percentage of short interest exploded to 26.1% of the reported interest. In the next 5 trading days, fails rose to 3,214,676 or 57% of the May reported short interest. Prior to May 10, 2006, there were few fails to deliver, indicating that the new fails to deliver were a result of newly reported shorted shares. The reported short interest for April 2006 was 4,859,221 and the reported short interest for May 2006 was 5,615,754, or a short interest increase of only 756,533 shares. The fails to deliver at the NSCC increased from the large volume of trading on May 9th and May 10th by 1,412,394 shares.

51. The May 9th and May 10th trading was reported in the May short interest period, with short interest growing by 756,533 shares. Since fails to deliver increased by 1.4 million shares, it appears that at least 655,861 shares that failed in delivery were not reported as short interest by Defendant clearing firms. These delivery failures represent sales of stock where no borrow could be obtained to complete settlement and shares were sold, but not owned by sellers (transactions which must be marketed short). Defendant clearing firms and market makers misrepresented the number of

shorted shares, which infused false and misleading information to the marketplace, at a time when they knew that Escala stock was failing to deliver; nonetheless, they continued to allow further failures to be traded, which impacted real supply and demand price discovery.

52. Reg SHO requires the exchanges to publish threshold lists identifying the stocks for which the number of shares that have failed to be delivered at DTCC's subsidiary, NSCC for at least five days exceeds (a) 0.5% of the issuer's outstanding common stock and (b) 10,000 shares. Prior to May 2006, Escala had been on and off the Reg SHO Threshold list three times, demonstrating previous failure to deliver because of the tight supply of available shares.

53. Short sellers of Escala stock failed to deliver 3,214,676 shares to the NSCC by May 17, 2006. Thus, short sellers were not borrowing shares for legitimate delivery (i.e., naked short selling) and were front running trades of real owners of Escala shares with shares that did not exist, using these trades to manipulate the pricing of Escala downward.

54. For May 2006, the NASDAQ issued a report identifying the largest volume traders by reporting Market Participants in Escala stock for the month, comprising 81% of the total market participant report volume:

Market Participant	***May 26 Reported Volume***	***Percentage of Volume***
Knight Equity Markets	31,984,624	45.16%
USB Securities, L.L.C.	12,096,879	17.08%
E*Trade Capital Markets, L.L.C.	9,034,783	12.76%

National Fin. Services, L.L.C.	4,158,568	5.87%
Total		80.87%

55. The Escala DTCC Inventory for May 2006 for the clearing firms for the traders identified above do not support the trade volumes by these Defendants. Since the four traders, Defendants Knight Equity Markets, L.P., USB Securities, L.L.C., E*Trade Capital Markets, L.L.C. and National Financial Services, L.L.C. accounted collectively for approximately 81% of the trading reported in market participant reports, it would be expected that these firms were trading significant volumes with each other and therefore, one of the firms' inventories would be significantly increasing while another firm would be significantly decreasing. However, this is not reflected in the DTCC tracking movement of shares, as set forth below.

56. Specifically, Market Participant(s):

a) Knight Equity Markets, L.P./CF Merrill Lynch, Trade Volume in May 2006 was 31,984,624 shares. The Clearing Firm inventory, calculated on a weekly basis was:

1) May 5, 2006-41,857 shares;

2) May 12, 2006-188,846 shares;

3) May 19, 2006--306,546 shares; and

4) May 26, 2006--272,946 shares.

b) UBS Securities, L.L.C., Trade Volume in May 2006 was 12,096,879 shares. The Clearing Firm inventory, calculated on a weekly basis was:

1) May 5, 2006 -- 48,830 shares;

2) May 12, 2006--225,139 shares;

3) May 19, 2006--256,900 shares; and

4) May 26, 2009--63,294 shares.

c) E*Trade Capital Markets, L.L.C., Trade Volume in May 2006 was 9,034,783 shares. The Clearing Firm inventory, calculated on a weekly basis was:

1) May 5, 2006--77,777 shares;

2) May 12, 2006--118,940 shares;

3) May 19, 2006--304,504 shares; and

4) May 19, 2006 was 394,000 shares.

d) National Financial Services, L.L.C., Trade Volume in May 2006 was 4,158,568 shares. The Clearing Firm inventory, calculated on a weekly basis was:

1) May 5, 2006 was 199,275 shares;

2) May 12, 2006 was 186,367 shares;

3) May 5, 2006 was 278,515 shares; and

4) May 19, 2006 was 463,410 shares.

57. The small movements of shares in the inventories of the Defendant clearing firms do not support settlements of 91 million shares executed in the marketplace during Relevant Period I with the real shares issued by Escala.

4. The Events of December 2006 (Relevant Period II)

58. In December 2006, Escala announced substantial changes to its Boards of Directors and Officers, stating that it would restate earnings for previous years beginning in 2003 and that the

restatements would be significant and material to its operation. However, the restatements were never put into effect.

59. There were substantial sales of Escala stock recorded in December 2006, despite:

a) its designation as SHO threshold security, which would have constrained large volumes of short sales unless the security was pre-borrowed to complete delivery;

b) the continued tight supply of available Escala shares; and

c) the still large short interest of 5,045,238 shares or 55% of the 9.1 million shares in the public float.

60. Approximate Number of Shares available to settle trades in December 2006.

Settlement Date	***12/1/ 2006***	***12/8/ 2006***	***12/15/ 2006***	***12/22/ 2006***	***12/29/ 2006***
Shares deposited with DTCC	9,092,4898	9,094,405	9,094,405	9,094,405	9,094,405
Non-Shortable Shares	1,900,000	1,900,000	1,900,000	1,900,000	1,900,000
Short Interest	5,110,988	5 110,988	5.045,238	5,045,238	5,045,238
Approx. Shares Available	2,081,501	2,083,417	2,149,167	2,149,167	2,149,659
Escala's Trade Volume					
Shares Traded		545,794	1,424,949	19,346,502	56,271,665

Between
Periods

61. In December 2006, the marketplace volume in Escala stock increased to 84.6 million shares, an increase of 30 times November's marketplace volume of 2.8 million shares. December's marketplace volume was a rotation of 9.3 times of all of Escala's shares on deposit at the DTCC, an average turnover of the DTCC shares every 2 days for the month. The majority of this volume, 79,282,758 shares or 94% of the December 2006 volume, transacted in just 6 trading days from December 19, 2006 through December 27, 2006, which equals the entire number of shares on deposit turning over every day during this period.

62. The 79 million shares traded in these six days could not have legally settled based on the movement of real shares at the DTCC. This volume could not have been short sales because there was no significant amount of shares to short. In fact, the short interest, while remaining over 5 million shares, actually decreased from December 2006 to January 2007.

63. Although the supply of Escala shares to trade was constrained in December 2006:

a) short interest stayed above 5 million shares;

b) shares outstanding remained stable;

c) 1.9 million shares were held in known ownership; and d) massive share volumes were sold without a significant increase in the fails to deliver to the NSCC.

64. Although there were almost 19 million

shares of Escala stock traded on December 19, 2006, there was a decrease in fails to 329,269 shares, a decline of 13,224 shares from the previous day. The fails to deliver peaked in December 2006 at slightly less than 1.3 million shares.

65. In the first 12 days in December 2006, the average closing price for a share of Escala stock was $4.88. On December 19th, the market opened at $5.00 and increased to a closing price of $8.60. The price continued to increase to a peak price on December 20th of $13.30. By January 8, 2007, the stock closed at $4.73 per share and by January 9th it closed at $4.54 a share.

66. For December 2006, the NASDAQ issued a report identifying the largest volume traders by reporting Market Participants in Escala shares, comprising 83.15% of the total market participant report volume:

Market Participant	***12/2006 Reported Volume***	***Percentage of Volume***
Knight Equity Markets, L.P.	16,556,363	27.39%
USB Securities, L.L.C.	11,153,215	18.45%
E*Trade Capital Markets, L.L.C.	14,476,559	23.95%
National Fin. Services, L.L.C.	4,725,698	7.82%
Citadel Derivatives Group, L.L.C.	3,349,785	5.54%
Total		83.15%

67. The Escala DTCC Inventory for December 2006 for the trader's clearing firms identified above do not support the trade volumes by these Defendants. Since the four traders, Defendants Knight Equity Markets, L.P., UBS Securities, L.L.C., E*Trade Capital Markets, L.L.C. and National Financial Services, L.L.C. accounted for 83.15% of the trading reported in Market

Participant reports for this period, the data would ordinarily reflect that these firms were trading significant volume with each other and therefore, one of the firms' inventories would be significantly increasing while another firm would be significantly decreasing. However, the DTCC tracking movement of shares does not support such conclusion.

68. For example, Market Participant(s):

a) Knight Equity Markets, L.P./CF Merrill Lynch, Trade Volume in December 2006 was 16,556,363 shares. The Clearing Firm inventory, calculated on a weekly basis was:

a) December 1, 2006--222,789 shares;

b) December 8, 2006--230,907 shares;

c) December 15, 2006-234,486 shares; and

d) December 22, 2006-219,497 shares.

b) E*Trade Capital Markets, L.L.C., Trade Volume in December 2006 was 14,476,559 shares. The Clearing Firm inventory, calculated on a weekly basis was:

a) December 1, 2006--391,844 shares;

b) December 8, 2006--319,393 shares;

c) December 15, 2006-370,602 shares;

d) December 22, 2006-334,703 shares; and

e) December 29, 2006 -511,101 shares.

c) UBS Securities, L.L.C., Trade Volume in December 2006 was 11,153,215 shares. The Clearing Firm inventory, calculated on a weekly

basis was:

a) December 1, 2006--133,448 shares;

b) December 8, 2006--127,121 shares;

c) December 15, 2006--94,13.1 shares;

d) December 22, 2006--77,513 shares; and

e) December 29, 2006--69,966 shares.

c) National Financial Services L.L.C., Trade Volume in December 2006 was 4,725,698 shares. The Clearing Firm inventory, calculated on a weekly basis was:

a) December 1, 2006--347,596 shares;

b) December 8, 2006--331,243 shares;

c) December 15, 2006-373,754 shares;

d) December 22, 2006-347,078 shares; and

e) December 29, 2006-499,437 shares.

d) Citadel Derivatives Group, L.L.C., Trade Volume in December 2006 was 3,349,785 shares. The Clearing Firm inventory, calculated on a weekly basis was:

a) December 1, 2006--452,183 shares;

b) December 8, 2006--140,348 shares;

c) December 15, 2006--55,672 shares; and

d) December 22, 2006--62,705 shares.

69. Combined NASDAQ Market Participation Reports for May and December 2006.

Market Participant	May 2006 Volume	December 2006 Volume	Total
Knight Equity Markets, L.P.	31,984,624	16,556,363	48,540,987
E*Trade Capital Markets	9,034,783	14,476,559	23,511,342
UBS Securities L.L.C.	12,096,879	11,153,215	23,250,094
National Financial Services	4,158,568	4,725,698	8,884,266
Citadel Derivatives, Group	1,603,235	3,349,785	4,953,020

70. Although there was almost 182 million shares of Escala stock traded in May 2006 and December 2006, settlement of this volume was unlikely given the accounting of the shares issued, the number of shares held in accounts that could not be shortened, inventory movement at the DTCC short sale data, the amount of previously shorted shares, and the number of shares failing to be delivered at the NSCC.

71. Defendants Knight Capital Group, Inc., through its subsidiary Knight Capital Americas, L.P., formerly known as Knight Equity Markets, L.P., was the largest trader by reported market participants in the stock of Escala for May and December 2006, with reported trade volumes of 31,984,624 shares in May 2006 and 16,556,363 shares in December 2006 for a combined total of 48,540,987 shares traded during these periods. Defendant Merrill Lynch acted as the clearing firm for the Knight Equity trades in May and December 2006.

72. Defendant UBS Securities, L.L.C. was a

significant trader by reported market participants in the stock of Escala for May and December 2006, with reported trade volumes of 12,096,879 shares in May 2006 and 11,153,215 shares in December 2006 for a combined total of 23,250,094 shares traded during these periods. Defendant UBS acted as the clearing firm for its trades.

73. Defendant E*Trade Capital Markets, L.L.C. was also a significant trader by reported market participants in the stock of Escala for May and December 2006, with trade volumes of 9,034,783 shares in May 2006 and 14,476,559 shares in December 2006 for a combined total of 23,511,342 shares traded during these periods. Defendant E*Trade Capital Markets, L.L.C. acted as the clearing firm for its trades.

74. Defendant National Financial Services, L.L.C. was another significant trader by reported market participants in the stock of Escala for May and December 2006, with trade volumes of 4,158,568 shares in May 2006 and 4,725,698 shares in December 2006 for a combined total of 8,884,266 shares traded during these periods. Defendant National Financial Services L.L.C. acted as the clearing firm for its trades.

5. Washed and Matched Trading

75. The massive trading volume in May and December 2006 were netted out as a pre-arranged washed and matched trading (e.g., washed is trading between related affiliates of a dealer; matched trades are between conspiring non related traders). High trade volumes without substantial inventories, lack of clearing firm inventory movements, no additional reported short interest and no significant increase in

"fails to deliver" were strong indications that the transactions in issue were intended solely for the purpose of adding artificial volume and thereby create an appearance of buying or selling by actual investors in a company, which is an unlawful practice.

76. The Defendant traders and/or clearing firms that engaged in conduct fostering or facilitating the naked short selling of Escala stock did so in breach of their duty as "gatekeepers" of the market to report suspicious transactions of unlawful naked short sales of stock to authorities. Since by their very nature, the fails to deliver represented sales of unregistered counterfeit securities that were not issued by Escala nor borrowed to deliver for legal settlement, by ignoring the obvious need for further inquiry, Defendants allowed Plaintiff's interests as shareholders of Escala to be diluted and thus, impaired.

77. There was so little movement of shares between the clearing firms, that settlements of the 91 million shares executed in the marketplace during the Relevant Period(s) were unsupportable.

78. The 182 million shares of Escala stock traded during the Relevant Period(s) is indicative by itself that the trading was manipulated by Defendants and not executed by real buyers and sellers, in the absence of buyers for Escala stock. The data reflects that there was an illegal bear raid on Escala securities, with massive volumes of non existent counterfeit stock used to manipulate pricing and front run trades ahead of the actual shareholders of Escala, including the Plaintiffs, with short sales being mis-reported to the marketplace.

Although Defendants, as market makers, traders and/or clearing firms, knew or in the alternative, should have known that Escala's stock was being short sold and in limited supply and therefore, that the shares were not being delivered for proper settlement, they actively participated in the trading of these securities, or alternatively, allowed it to occur.

79. Upon information and belief, to conceal their unlawful naked short selling of Escala stock, Defendants:

a. created false documentation of their trading, loaning and ownership in Escala shares;

b. failed to complete an order ticket for their securities transactions involving Escala shares that would ordinarily have permitted securities regulators to determine the amount of short sales that Defendants, acting as a prime broker, transacted and the identity of the parties involved in the short sale; and

c. knowingly and intentionally mis-marked order tickets to make transactions appear as "long" sales when in fact, they were short sales and concealed these unlawful activities by falsely reporting counterfeit or phantom shares on brokerage statements to investors, including the Plaintiffs in order to mislead them.

80. Upon information and belief, Defendants unlawfully used Rule 144 Restricted Stock in their possession to cover their own naked short sales or help other Defendants and/or third parties to cover

their own naked short sales of Escala stock and used stock designated as "Do Not Lend" to conceal and cover-up their own Fails to deliver resulting from their unlawful activity.

6. Pattern of unlawful short sales of securities by Defendants

81. Defendants have been engaged unlawfully for years in a pattern of repeated naked short selling of securities involving victims similarly situated as those of the Plaintiffs, utilizing the same or similar schemes as they employed in sales of Escala stock during the Relevant Period(s).

82. There have been numerous claims made and/or lawsuits filed against some or all of the Defendants by aggrieved shareholders, with sanctions imposed by regulators. For example, the Financial Industry Regulatory Authority ("FINRA") and other regulatory agencies filed complaints against Defendant Merrill Lynch, dating back to at least 2007, charging it with, inter alia:

a) effectuating short sale transactions in certain securities and failing to make an affirmative determination prior to affecting such transaction. Resolution date: August 20, 2004. Sanction Amount: $9,000.00.

b) effectuating short sale transactions in securities, failing to make an affirmative determination prior to affecting such transaction, executing short sale transactions and failing to report these transactions as required by law with a short sale modifier: Resolution Date: October 27, 2004. Sanction amount:

$97,000.00;

c) failing to report the correct symbol indicating whether transactions in eligible securities were a buy, sell, sell short, short Exempt or Cross for Transaction in reportable securities. Resolution Date: March 23, 2006. Sanction Amount: $45,000.00;

d) failing to report the correct symbol indicating whether transactions were buy, sell, sell short, sell short Exempt or Cross for Transaction in reportable securities. Resolution Date: September 24, 2008. Sanction amount: $242,500.00;

e) having a fail to deliver position in a threshold security for 13 consecutive settlement days and failing to timely allocate and close out its fail to deliver position. Subsidiary or affiliated company: Merrill Lynch Professional Clearing Corp. Resolution Date: June 26, 2007. Sanction amount: $1,250,000;

f) submitting inaccurate short interest position reports in NASDQ Securities to NASD, submitting inaccurate short interest position reports in securities listed on the NYSE to the NYSE, thereby impairing ability of the OATS system to link execution reports to related trade report. Subsidiary or affiliated company: Merrill Lynch Professional Clearing Corp. Resolution Date: May 27, 2010. Sanction amount: $47,500. See Exhibit A, annexed hereto.

83. FINRA and other regulatory agencies also filed complaints against Defendant UBS dating back to at least 2008, charging it with inter alia:

a) accepting customer short sale orders in certain securities and for, each order failed to make an affirmative determination that the firm would receive delivery of the security on behalf of the customer or that the firm could borrow the security on behalf of the customer for delivery by the settlement date, affecting short sale orders in certain securities and for itself, for each order failing to make an affirmative determination that the firm would receive delivery of the security or could borrow the security by the settlement date. Resolution Date: June 26, 2008. Sanction amount: $116,000.00.

b) submitted reports to OATS that contained inaccurate, incomplete or improperly formatted data and erroneously submitted Execution Reports routed away for handling and/or execution to OATS. Resolution Date: March 2007. Sanction amount: $65,000.00. See Exhibit A, annexed hereto.

84. On October 24, 2011, FINRA issued a Letter of Acceptance to Defendant UBS, "*Financial Industry Regulatory Authority Letter of Acceptance, Waiver and Consent No. 20080144511* ("Letter"). In the Letter, FINRA set forth its basis for settlement of an investigation commenced by its Department of Enforcement ("DOE") against UBS with regard to its long standing pattern of securities law violations for short selling activities.

85. While not admitting or denying the allegations made against it, UBS accepted and consented to entry of findings by FINRA (the

"Findings"), which included the following:

> UBS's Reg SHO supervisory and compliance system regarding locates and order marking of short sale orders was significantly flawed and resulted in a systemic supervisory failure that contributed to serious Reg SHO failures across the Firm's equities trading business." Id., at 2. "During the Relevant Period, the Firm's extensive locate violations occurred due to: (1) the misapplication of exceptions to Reg SHO's locate requirement...; (2) the inclusion of certain threshold and hard-to-borrow securities on the Firm's easy-to-borrow list...; (3) the Firm permitting certain clients to bypass the locate requirement when entering short sales...; and (4) the Firm failing to reasonably supervise that locates were obtained and/or documented for short sales entered through the Firm's Order Entry Systems. Id., at 3.
>
> As a result of these failures, the Firm improperly entered **millions of proprietary and customer short sale orders** at various times during the Relevant Period without having reasonable grounds to believe that the securities could be borrowed and available for delivery. A significant number of these short sale orders were in hard-to-borrow securities. Extrapolating from the quantified violations indicates that during the Relevant Period, **the Firm likely entered tens of millions of proprietary**

and customer short sale orders without having reasonable grounds to believe that the securities could be borrowed and available for delivery. The duration, scope and volume of the trading created a potential for harm to the integrity of the market. Id., at 3. (Emphasis added).

Additionally, the Firm mismarked millions of sale orders in its trading systems at various times during the relevant Period. Extrapolating from the quantified violations indicates the Firm likely mismarked **tens of millions of sale orders** during the Relevant Period. (Emphasis added). Many of these mismarked orders were short sales that were mismarked as "long" resulting in additional significant violations of Reg SHO's locate requirement. Id.

Moreover, the Firm also had significant reporting and record keeping violations resulting from the foregoing. UBS's mismarked sale orders flowed through to the Firm's blue sheet submissions, causing it to make inaccurate submissions of trading data to FINRA. ... Id.

Enforcement tested short sales entered through more than a dozen of the Firm's Order Entry Systems (OES's) during the three month period June 1, 2006 to August 31, 2006 (the "Sample Period"). Enforcement's investigation uncovered approximately 700,000 short sales that were effectuated without locates during

the Sample Period based upon improper applications of the exceptions to the locate requirement as described above. Given that the Firm improperly applied these exceptions in some cases for several years, extrapolating from the number of violations quantified during the Sample Period indicates that the Firm likely effected more than **ten million short sales in improper reliance** on an exception to Reg SHO's locate requirement. Id., at 5. (Emphasis added).

The Firm incorrectly programmed a trading system so that two proprietary trading strategies treated all short sale orders in Exchange Traded Funds ("ETFs") as if they were exceptions to Reg SHO's locate requirement. ... During the Sample Period, the Finn effected approximately 680,000 proprietary short sale orders in ETF's without locates using these two trading systems. ... [E]xtrapolating from the number of violations quantified during the Sample Period indicates that the Firm likely effected more than 7.4 million short sales in ETFs without valid locates." *Id.* "During the period beginning January 3, 2005 until approximately April 3, 2008, the Firm also improperly treated certain equity hedge transactions ... as exceptions to Reg SHO's locate requirements. ..." Id., at 6.

[T]he Firm created and distributed ETB (easy-to-borrow) lists that improperly included threshold and HTB (hard-to-

> borrow) securities to UBS's proprietary traders and clients, resulting in more than 900,000 short sale orders that were released for execution without valid locates." *Id.* "The Firm's DES platform was normally designed to block short sale orders that did not contain an entry indicating that a located had first been obtained. However, the Firm altered the programming for these 270 DES Clients to bypass this standard DES platform check. As a result, the clients configured to bypass the locate check had the ability to route short sale directly to the market for execution without locates ... Id., at 8.

See Exhibit B, annexed hereto. As a result of the FINRA Letter, UBS consented to a $12,000,000.00 sanction.

86. Despite the existence of regulatory prohibitions barring the practice of naked short selling of stock, Defendants' unlawful manipulation of the value of Escala shares was not an isolated incident but a regular course of dealing that resulted in the creation and circulation of millions of unauthorized and/or counterfeit Escala shares, thereby diluting and artificially depressing the value of the authorized shares of Escala owned by Plaintiffs during the Relevant Period(s).

87. By unlawfully flooding the market with unauthorized, fictitious and/or counterfeit Escala shares, Plaintiff's interests as share holders of Escala to a fixed percentage ownership of the company stock and associated voting rights were diluted, to their substantial detriment. Moreover,

Defendants' unlawful conduct created uncertainty in the market regarding the integrity of Escala and its management, which caused further depression in the value of the Escala stock..

COUNT ONE
N.J.S.A. 2C:41-2c.

88. Plaintiffs repeat and reallege each and every allegation set forth in Paragraphs 1-87 of the Complaint, as if incorporated by reference herein.

89. Plaintiffs are "persons" within the meaning of N.J.S.A. 2C:41-1b.

90. Each of the Defendants is a "person" within the meaning of N.J.S.A. 2C:41-lb.

91. Defendants Merrill Lynch, Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E*Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives, L.L.C. and ABC Companies 1-10 (names being fictitious) acting independently and/or by and through its subsidiaries, affiliates, related entities, agents, servants or employees or collectively each constituted a separate "enterprise" engaged in or the activities of which affected trade or commerce in New Jersey within the meaning of N.J.S.A. 2C:41-1c.

92. Defendants John Does 1-10 (names being fictitious) are "persons" within the meaning of N.J.S.A. 2C:41-lb. each employed by or associated with these enterprise(s), who conducted, managed, operated or participated, directly or indirectly in the conduct of each separate enterprise's affairs through a pattern of predicate acts or crimes as defined by N.J.S.A. 41-1a. and by multiple, repeated and

continuous acts knowingly and willfully committed violations of the New Jersey Racketeering Influenced and Corrupt Organization Act, N.J.S.A. 2C:41-1 et seq., including but not limited to N.J.S.A. 2C:41-2c., and inter alia, the predicate criminal acts set forth in N.J.S.A. 2C:41- 1 a.(n), "theft and all crimes defined in Chapter 20 of Title 2C of the New Jersey Statutes" and (p) "fraud in the offering, sale or purchase of securities".

93. In engaging in at least two incidents of predicate acts in the past ten years, as set forth herein, Defendants, in their capacity as enterprises, participated in racketeering activity embracing criminal conduct involving Escala that was not isolated and had either the same or similar purpose, results, participants or victims or methods of commission that are otherwise interrelated by distinguishing characteristics.

94. The pattern of predicate acts committed by Defendants, in their capacity as enterprises, is continuing, is substantial in nature and poses a threat of continuing in the future because they amount to a regular course of doing business.

95. Plaintiffs were injured in their business or property as a result of Defendants' predicate criminal acts committed in violation of N.J.S.A. 41-1a. [e.g., theft pursuant to subsection (n) and fraud in the offering, sale or purchase of securities pursuant to subsection (p)] committed by Defendants with the knowledge and intent that they were acting in furtherance of a pattern of racketeering activity.

A. Violations of New Jersey Uniform Securities Law, N.J.S.A. 49:3-49 et seq.

96. Defendants' conduct constituting criminal predicate acts of racketeering activity as defined by N.J.S.A. 2C:41-1a. (p) include but are not limited to, the following:

a) Willfully employing a device, scheme, or artifice to defraud in connection with an offer to sell, sale or purchase any security;

b) Willfully engaging in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a person;

c) Willfully effecting a transaction in a security which involves no change in the beneficial ownership of the security for the purpose of creating a false or misleading appearance of active trading in a security or with respect to the market for a security;

d) Willfully misappropriating, converting or improperly withholding funds or other property;

e) Willfully selling or offering for sale unregistered, unauthorized, fictitious and/or counterfeit Escala shares; and/or

f) Wilfully employing a deceptive or fraudulent device, scheme or to manipulate the market in the security.

97. As the market for Escala stock was intended to operate in an efficient and honest

Manner, Plaintiffs relied upon the assumption that the market for Escala stock was free from manipulation.

98. Defendants, by each knowingly and intentionally engaging in the conduct described herein, (e.g., selling Escala stock short at times when Defendants neither possessed nor intended to obtain Escala stock to deliver by the Settlement Date and by creating and trading in unauthorized, fictitious, and/or counterfeit Escala shares) Defendants willfully violated, attempted to violate, aided and abetted, and solicited another to willfully violate the New Jersey Uniform Securities Law, N.J.S.A. 49:3-47 et seq., which prohibits "generally, any course of conduct or business which is calculated or put forward with intent to deceive the public or the purchaser of any security or investment advisory services as to the nature of any transaction or the value of such security".

99. Defendants, by making phantom loans of counterfeit Escala stock to facilitate naked short sale transactions, engaged inter alia, in the employment of an "artifice, agreement, device or scheme to obtain money, profit or property by any of the means herein set forth or otherwise prohibited by [the New Jersey Uniform Securities Law, N.J.S.A. 49:3-47 et seq.]"

100. The SEC has expressly noted that naked short selling involves the omission of a material fact. Defendants, by each knowingly and intentionally engaging in the conduct as described herein, (e.g., selling Escala stock short at times when they neither possessed nor intended on obtaining Escala stock to deliver by the Settlement Date and by creating and trading in unauthorized, fictitious, and/or counterfeit

Escala shares), made untrue statements of a material fact or omissions of material facts necessary in order to make the statements made, in light of the circumstances under which they were made not misleading, in violation of the New Jersey Uniform Securities Law, N.J.S.A. 49:3-47 et seq.

101. Further, upon information and belief, Defendants, in violation of the New Jersey Uniform Securities Law, N.J.S.A. 49:3-47 et seq.:

a) Knowingly and intentionally charged clients, customers, banks or others, fees, commissions and/or interest for "loaning" shares of stock that the Defendants never loaned;

b) Knowingly and intentionally permitted a pattern of allowing failure to deliver or receive positions from the same counter-party or for the same customers/ clients;

c) Knowingly and intentionally failed to conduct or request buy-ins from clients or counterparties;

d) Knowingly and intentionally continued to accept, permit or facilitate short sales or other transactions (e.g., flex options, conversions) for a customer or a prime broker that had failed to deliver on numerous occasions;

e) Knowingly and intentionally continued to accept, permit or facilitate short sales of a stock that had repeated net failures to deliver or receive;

f) Knowingly and intentionally permitted, facilitated and/or engaged in conversion,

reverse conversion, flex option or other transactions that they knew were unlawful;

g) Knowingly and intentionally permitted, facilitated and/or engaged in transactions with customers/clients that it knew intended on violating or circumventing the law;

h) Knowingly and intentionally permitted, facilitated and/or engaged in transactions where they knew that stock would not be borrowed and/or delivered because of a negative rate (e.g., it would cost money to borrow the stock);

B. Theft By Taking (N.J.S.A. 2C:20-2)

102. Defendants' violations of N.J.S.A, 2C:20-2 et seq., constituted the commission of the offenses of theft, a predicate act of racketeering activity as set forth in N.J.S.A. 2C:41-1(n).

103. A person commits the offense of theft when he/she unlawfully takes or, being in lawful possession thereof, unlawfully appropriates property of another with the intention of depriving him/her of the property, regardless of the manner in which the property is taken or appropriated.

104. Plaintiffs held a property interest in their authorized issued shares of Escala stock and all rights appertaining thereto. Since at any point in time there is a finite amount of authorized and issued Escala stock, when the Defendants created fictitious and/or counterfeit stock through naked short sales, they diminished and/or diluted from each legitimate owner of authorized and issued

Escala stock, an amount proportionate to the amount of fictitious and/or counterfeit Escala shares they created.

105. Each Defendant committed, attempted to commit, aided and abetted, solicited another to commit, or engaged in acts constituting the offense of theft by taking the property of Escala and Escala shareholders, including Plaintiffs. Upon information and belief, Defendants unlawfully took the property of Plaintiffs, with the intention of depriving them of that property by, inter alia, selling Escala stock short at times when they neither possessed nor intended on obtaining Escala stock to deliver by the Settlement Date and by creating and trading in unauthorized, fictitious, and/or counterfeit Escala shares. By so doing, Defendants took, in whole or in part, shares of Escala stock, which had not been issued or authorized to be issued, for which Escala was never paid, and thereby deprived Escala (and Plaintiffs, as shareholders of the company) of the right to exclusive possession and control over this property and any financial benefit from the introduction of its shares into the marketplace.

106. Further, Defendants engaged in theft by taking by purporting to loan short sellers Escala stock that the Defendants did not own nor had any intention of obtaining and never did obtain. Upon information and belief, Defendants charged short sellers fees for these sham "loans" of stock. Thus, the creation of fictitious and/or counterfeit shares of Escala through the unlawful naked short sales of counterfeit stock and the fees Defendants charged for these sham loans constituted an unlawful taking of property in violation of N.J.S.A. 2C:20-2.

107. As stated herein, Defendants engaged in similar unlawful naked short selling of counterfeit securities of other companies for which they earned illicit profits and fees. The illegal naked short selling engaged in by the Defendants were not isolated incidents or parts of the same transaction but rather constituted a regular way or course of conduct of each of the Defendants, acting in their capacity as enterprises, involving a pattern of racketeering activity that spanned several years, by which Defendants derived, directly or indirectly, personal property including money.

C. Theft By Deception (N.J.S.A. 2C:20-4)

108. Defendants' violations of N.J.S.A. 2C:20-4 et seq., constituted the commission of the offense of theft by deception, a predicate act of racketeering activity as set forth in N.J.S.A. 2C:41-1(n).

109. A person commits the offense of theft by deception when he/she purposely obtains the property of another by deception, which means that the Defendants unlawfully brought about a transfer or an apparent transfer of a legal interest in the property either to the Defendant or to another person. A person deceives another if he/she purposely 1) creates or reinforces a false impression, including false impressions as to law, value, intention, or other state of mind or 2) prevents another from acquiring information which would affect his/her judgment of a transaction.

110. Defendants, by inter alia, engaging in the unlawful naked short sale of counterfeit Escala shares based on promises to borrow Escala stock that it did not borrow and had no intention of borrowing, committed the crime of theft by deception

prohibited by N.J.S.A. 2C:20-4.

111. The multiple acts of racketeering committed by the Defendant enterprises in violation of the New Jersey Racketeering Influenced and Corrupt Organization Act N.J.S.A. 2C:41-1 et seq. were interrelated, part of a common and continuous pattern of fraudulent conduct perpetrated for the same or similar purposes, thus constituting a regular way of doing business by each separate Defendant enterprise, that is a pattern of racketeering activity as defined by the N.J. S.A. 2C:41-1d.(1) and (2) by each of the Defendants, acting in their capacity as enterprises.

112. Each of the Defendant enterprises willfully, knowingly, and intentionally participated in these separate but related schemes to defraud Plaintiffs and engaged in a pattern of racketeering activity described herein as a regular way of doing its business with the knowledge and the intention that Plaintiff would be defrauded by their conduct.

113. As a direct and proximate result of each of the Defendants' wrongful acts, Plaintiffs have been injured and sustained substantial damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is, Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives, Group L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for statutory trebled damages, attorney's fees, interest and costs of suit.

COUNT TWO
N.J.S.A. 2C:41-2a.

114. Plaintiffs repeat and reallege each and every allegation set forth in Paragraphs 1-113 of the Complaint, as if incorporated by reference herein.

115. Plaintiffs are "persons" within the meaning of N.J.S.A. 2C:41- 1 b.

116. Each of the Defendants are "persons" within the meaning of N.J.S.A. 2C:41 -1b .

117. Each Defendant enterprise, that is, Merrill Lynch, Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives, L.L.C. and ABC Companies 1-10 '(names being fictitious) acting independently and/or by and through its subsidiaries, affiliates, related entities, agents, servants or employees or collectively constitute a separate "enterprise" within the meaning of N.J.S.A. 2C:41-lc.

118. Defendants John Does 1-10 (names being fictitious) are "persons" within the meaning of N.J.S.A. 2C:41-lb, separately employed by or associated with each Defendant enterprise who conducted, managed, operated or participated, directly or indirectly in the conduct of each Defendant enterprise's affairs through a pattern of predicate acts or crimes as defined by N.J.S.A. 41-1a. and as such, by a pattern of multiple, repeated and continuous acts, knowingly and willfully committed violations of the New Jersey Racketeering Influenced and Corrupt Organization Act, N.J.SA. 2C:41- 1 et seq., specifically N.J.S.A. 2C:41-2a. that makes it unlawful for any person who has received

income derived, directly or indirectly from a pattern of racketeering activity to use or invest, directly or indirectly any part of the income, or the proceeds of the income in acquisition of any interest in, or the establishment or operation of any enterprise engaged in or the activities of which affect trade or commerce through the use of predicate criminal acts defined by N.J.S.A. 2C:41-1a., including but not limited to subsection (n)"theft and all crimes defined in Chapter 20 of Title 2C of the New Jersey Statutes" and (p) "fraud in the offering, sale or purchase of securities".

119. Each Defendant enterprise, engaging in at least two incidents of unlawful criminal acts as set forth herein, did so as a regular way of doing business that was not isolated, and engaged in unlawful conduct, including but not limited to creating false documentation of their trading, loaning and ownership in shares of Escala and other victims similarly situation and participated in racketeering activity embracing criminal conduct that had either the same or similar purpose, results, participants or victims or methods of commission or which was otherwise interrelated by distinguishing characteristics, in violation of N.J.S.A. 2C:41-2a.

120. The pattern of predicate acts committed by each Defendant enterprise is continuing, substantial in nature and poses a threat of continuing in the future because these acts amount to a regular way doing business by each of the Defendant enterprises.

121. Plaintiffs were injured in their business or property as a result of Defendants' committing unlawful criminal acts as defined by N.J.S.A. 41-1a.

(e.g., theft pursuant to subsection (n) and fraud in the offering, sale or purchase of securities pursuant to subsection (p), amongst others) with the knowledge and intent that they were acting in furtherance of a pattern of racketeering activity in violation of N.J.S.A. 2C:41-2a.

122. As a direct and proximate result of Defendants' wrongful conduct, Plaintiffs have been injured and have sustained substantial damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is, Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives, Group L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for statutory treble damages, attorney's fees, interest and costs of suit.

COUNT THREE
UNJUST ENRICHMENT

123. Plaintiffs repeat and reallege each and every allegation set forth in Paragraphs 1-122 of the Complaint as if incorporated by reference herein.

124. Each Defendant enterprise, while engaged in naked short selling of counterfeit shares of Escala stock in its business knew or, in the alternative, should have known that their artificial manipulation of Escala's stock value would directly and negatively impact Plaintiff's financial expectations and contractual rights as a shareholder in Escala, while providing Defendants with significant financial gain.

125. Each Defendant enterprise's unlawful manipulation of the market for Escala stock unjustly enriched themselves at Plaintiffs' expense, such that retention of these benefits would be inequitable.

126. As a result of each Defendant enterprise's unlawful conduct, Plaintiffs expectations of financial gain under ordinary market conditions was denied, to their substantial detriment.

127. As a direct and proximate result of each Defendant enterprise's actions, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that , Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel, Group. L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for compensatory damages, attorney's fees, interest and costs of suit.

COUNT FOUR
UNLAWFUL INTERFERENCE WITH PLAINTIFF'S ECONOMIC ADVANTAGE

128. Plaintiffs repeat and reallege each and every allegation set forth in Paragraphs 1-127 of the Complaint as if incorporated by reference herein.

129. Plaintiffs had a reasonable expectation of economic advantage or benefit as a result of their acquisition of Escala stock.

130. Each Defendant enterprise knew, or in the alternative, should have known of Plaintiffs'

expectancy of economic advantage by their ownership of Escala stock.

131. Each Defendant enterprise's conduct in inter alia, engaging in the unlawful naked short selling of counterfeit Escala Stock was wrongfully undertaken without justification as a result of which, Plaintiffs' expectation of economic advantage or benefit was impaired to their substantial detriment.

132. But for the Defendant enterprise's wrongful conduct, it is reasonably likely that Plaintiffs would have realized their economic advantage or benefit by their acquisition of Escala stock.

133. As a direct and proximate result of each Defendant enterprise's unlawful interference with Plaintiffs' economic advantage, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is, Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives Group, L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for compensatory damages, attorney's ' fees, interest and costs of suit.

COUNT FIVE
TORTIOUS INTERFERENCE WITH PLAINTIFF'S CONTRACTUAL RELATIONS

134. Plaintiffs repeat and reallege each and

every allegation set forth in Paragraphs 1-133 of the Complaint as if incorporated by reference herein.

135. Plaintiffs' purchase or acquisition of shares of stock in Escala was for investment purposes and undertaken pursuant to a contract.

136. Each Defendant enterprise knew, or in the alternative, should have known of the existence of that relationship by virtue of Plaintiffs' status as a shareholder in Escala.

137. Defendants intentionally and maliciously with motive to harm and without justification, interfered with Plaintiffs' contract with Escala by engaging inter alia, in the unlawful naked short selling of counterfeit shares of stock by inducing, procuring or causing a breach or termination of Plaintiffs' contractual relationship.

138. In the alternative, each Defendant enterprise, if it did not act out of malice, but rather for profit or to enhance its financial position, engaged in conduct affecting Plaintiffs that went far beyond or transgressed generally accepted standards of morality, that is a violation of standards of socially acceptable conduct.

139. But for each Defendant enterprise's conduct, Plaintiffs would have continued to own their shares of Escala stock and would not have suffered losses in the share value of Escala stock.

140. As a direct and proximate result of each Defendant enterprise's actions, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is, Merrill Lynch, Pierce, Fenner & Smith, Inc.,

Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives Group, L.L.C. John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for compensatory damages, attorney's fees, interest and costs of suit.

COUNT SIX
UNLAWFUL INTERFERENCE WITH CONTRACTUAL RELATIONS

141. Plaintiffs repeat and realleges each and every allegation set forth in Paragraphs 1-140 of the Complaint as if incorporated by reference herein.

142. Plaintiffs had the right to enjoy the fruits and advantages of their enterprise, industry and skill, free from unjustified and wrongful interference by their investment in Escala stock.

143. Each Defendant enterprise, by inter alia, engaging in the unlawful naked short selling of counterfeit shares of Escala stock, unjustifiably interfered with Plaintiffs contract rights and/or reasonable expectations derived therefrom.

144. But for each of the Defendant enterprise's unlawful activity, Plaintiffs would have realized their economic advantage or benefit.

145. As a direct and proximate result of each Defendant enterprise's actions, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as

Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives Group, L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for compensatory damages, attorney's fees, interest and costs of suit.

COUNT SEVEN
THIRD PARTY BENEFICIARY CLAIMS

146. Plaintiffs repeat and realleges each and every allegation set forth in Paragraphs 1-145 of the Complaint as if incorporated by reference herein.

147. Plaintiffs are the intended third party beneficiaries individually and/or as a class of any and all agreements and/or contracts entered into by each Defendant enterprise in furtherance of their roles as market makes, traders and clearing firms in their transacting short sales of Escala stock.

148. Upon information and belief, each Defendant enterprise intended that Plaintiffs, individually and as a class were to receive a benefit from these agreements and/or contracts.

149. As a direct and proximate result of each Defendant enterprise's failure to abide by their agreements and/or contracts, whether by intention, design or otherwise, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is, Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., Et Trade Capital Markets L.L.C., National

Financial Services, L.L.C., Citadel Derivatives Group, L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for compensatory damages, attorney's fees, interest and costs of suit

COUNT EIGHT
BREACH OF COVENANT OF GOOD FAITH AND FAIR DEALING

150. Plaintiffs repeat and realleges each and every allegation set forth in Paragraphs 1-149 of the Complaint as if incorporated by reference herein.

151. In any and all agreements and/or contracts entered into in which Plaintiffs were participants or intended third party beneficiaries individually or as a class, there is an implied covenant of good faith and fair dealing which requires that all parties to same must act in good faith and deal fairly with the other party in performing or enforcing the terms of the agreement and/or contract.

152. Each Defendant enterprise, by engaging inter alia in the unlawful naked short selling of counterfeit shares of Escala stock acted in bad faith, dishonestly or with improper motive to destroy or injure the right of Plaintiffs individually, or in their capacity as shareholders of Escala, to receive the benefits or reasonable expectation of their agreement or contract as third party beneficiaries.

153. Each Defendant enterprise, with no legitimate purpose: a) acted with bad motives or intentions; or b) engaged in deception or evasion in the performance of their agreement and/or contract; and by so doing denied Plaintiffs the benefit of the bargain as originally intended by the parties.

154. As a direct and proximate result of each Defendant enterprise's conduct, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is, Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives Group, L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for compensatory damages, attorney's fees, interest and costs of suit.

COUNT NINE
NEGLIGENCE

155. Plaintiffs repeat and realleges each and every allegation set forth in Paragraphs 1-154 of the Complaint as if incorporated by reference herein.

156. Each Defendant enterprise owed Plaintiffs a duty of care in their capacity as gatekeepers of the market.

157. Each Defendant enterprise, in engaging in conduct that fostered or facilitated the naked short sales of Escala stock breached the duty of care that they owed to the Plaintiffs to report suspicious transactions of naked short sales of the Escala stock in May 2006 and December 2006.

158. As a direct and proximate result of each Defendant enterprise's negligence, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that

is, Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives Group, L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for compensatory damages, attorney's fees, interest and costs of suit.

COUNT TEN
PUNITIVE AND EXEMPLARY DAMAGES

159. Plaintiffs repeat and realleges each and every allegation set forth in Paragraphs 1-158 of the Complaint as if incorporated by reference herein.

160. Each Defendant enterprise's actions were undertaken willfully, wantonly and maliciously.

161. As a direct and proximate result of each Defendant enterprise's actions, Plaintiffs have suffered damages.

WHEREFORE, Plaintiffs demand separate judgments against each Defendant enterprise, that is, Merrill Lynch, Pierce, Fenner & Smith, Inc., Knight Capital Americas, L.P., formerly known as Knight Equity Markets L.P., UBS Securities, L.L.C., E* Trade Capital Markets L.L.C., National Financial Services, L.L.C., Citadel Derivatives Group, L.L.C., John Does 1-10 (names being fictitious) and ABC Companies 1-10 (names being fictitious) for punitive and exemplary damages, attorney's fees, interest and costs of suit.

NEAL H. FLASTER, L.L.C.
Attorneys for Plaintiffs Greg Manning, et al

By: */s/ Neal H. Flaster*
Neal H. Flaster

Dated: June 5, 2012

JURY DEMAND

Plaintiff demands a trial by jury on all issues so triable.

/s/ Neal H. Flaster
Neal H. Flaster

Dated: June 5, 2012